

---

The Parliament of the Commonwealth of Australia

# Report 411

**Progress on equipment acquisition and financial reporting in  
Defence**

Joint Committee of Public Accounts and Audit

August 2008  
Canberra

---

© Commonwealth of Australia 2008  
ISBN 978-0-642-79049-1 (Printed Version)  
ISBN 978-0-642-79050-7 (HTML Version)



# Contents

Foreword .....	vii
Membership of the Committee (41st Parliament) .....	ix
Members of the Sectional Committee (41st Parliament) .....	x
Committee Secretariat (41st Parliament).....	x
Membership of the Committee (42nd Parliament) .....	xi
Members of the Sectional Committee (42nd Parliament) .....	xii
Committee Secretariat (42nd Parliament) .....	xii
Terms of reference .....	xiii
List of abbreviations .....	xiv
List of findings and recommendation.....	xvi
Committee findings .....	xvi
The Kinnaird Reforms .....	xvi
Measuring Outcomes.....	xvii
Transparency and Accountability – Major Projects Report.....	xvii
Recommendation .....	xviii
Executive summary .....	xix
Introduction .....	xix
Financial reform .....	xx
The Kinnaird reforms.....	xx
The case studies .....	xxi
Major Projects Report .....	xxii
Conclusion .....	xxiii

---

**THE REPORT**

<b>1</b>	<b>Introduction</b> .....	<b>1</b>
	Background .....	1
	Previous reviews .....	3
	Programs of reform.....	4
	Financial remediation .....	4
	Kinnaird reforms.....	5
	Purpose of inquiry .....	6
	Further developments .....	6
	Structure of report .....	6
	Conduct of inquiry .....	7
<b>2</b>	<b>Financial reform</b> .....	<b>9</b>
	Background .....	9
	The remediation program .....	11
	Remediation plans .....	11
	Update on remediation plans .....	27
	Position papers and adoption of the AEIFRS .....	46
	Summary of progress on remediation program .....	50
	Defence Management Review (DMR).....	53
	Defence Business Improvement Board.....	55
	International comparisons .....	56
	Conclusions.....	58
<b>3</b>	<b>The Kinnaird reforms</b> .....	<b>61</b>
	Background .....	61
	Organisational implementation of the recommendations .....	63
	Communicating with government: Matching capability to strategy .....	64
	Defining and assessing capability .....	65
	Managing capability .....	83
	Procuring and supporting Defence equipment .....	86
	Summary of progress on implementation of recommendations .....	93
	Measurement of reform effectiveness.....	97

International comparisons .....	101
Conclusions.....	104
<b>4 The case studies .....</b>	<b>107</b>
<b>Introduction .....</b>	<b>107</b>
<b>Fast Frigate Guided (FFG) Upgrade, Project Sea 1390 .....</b>	<b>108</b>
Project background .....	108
Issues identified by the ANAO.....	109
<b>Tiger Armed Reconnaissance Helicopter (ARH) Project – Air 87 .....</b>	<b>113</b>
Project background .....	113
Issues identified by the ANAO.....	114
<b>Key concerns.....</b>	<b>115</b>
Lack of rigour in project/contract management .....	116
Indiscipline – inventory management .....	122
Reticence to recover damages.....	125
Military-off-the-shelf.....	130
Risk allocation.....	134
Personnel – recruitment, training and retention.....	138
Maintaining corporate knowledge – lessons learnt.....	144
Cultural change .....	147
<b>Current status of the projects .....</b>	<b>150</b>
FFG Upgrade Project .....	150
Tiger Armed Reconnaissance Helicopter (ARH) Project – Air 87.....	153
<b>Conclusions.....</b>	<b>155</b>
<b>5 Major Projects Report .....</b>	<b>157</b>
<b>Introduction .....</b>	<b>157</b>
<b>International models of reporting .....</b>	<b>158</b>
The US GAO Defense Acquisitions Assessments of Selected Weapon Programs.....	158
The UK NAO Ministry of Defence Major Projects Report .....	159
<b>Department of Defence, Major Projects Report.....</b>	<b>161</b>
<b>Improving transparency .....</b>	<b>164</b>
Minimising ambiguity.....	164
A holistic approach.....	166

Whole of life .....	168
Context.....	169
Relationship between the ANAO and the DMO.....	169
Current status of the Major Projects Report .....	171
Conclusions.....	173

## **APPENDICES**

Appendix A – List of submissions.....	177
Appendix B – List of exhibits .....	179
Appendix C – List of public hearings.....	183
Appendix D – List of inspections.....	189
Appendix E – Financial reporting challenges facing selected international Defence organisations.....	191
Appendix F – FFG Upgrade Project delivery schedule .....	195



## Foreword

The Defence portfolio has been the subject of a great deal of Parliamentary scrutiny over many years. There has been good reason for this. At the same time as the Department of Defence has been the beneficiary of generous funding it has suffered from deficiencies in its financial reporting and its capacity to acquire major equipment on time and on budget.

In fulfilling its statutory obligation to review all of the reports of the Auditor-General tabled in Parliament, the Committee has become well apprised of the challenges that Defence faces. Over and again, the Committee, and indeed the Australian public, have heard about major Defence acquisition projects that have gone wrong. Similarly, Defence's inability to attest to the accuracy of its financial statements for the years 2003-04 and 2004-05 is well known. In 2003, as a result of two major reviews and the uncertain financial position in which it found itself, Defence was under intense pressure to make changes. The primary purpose of this inquiry was to determine the extent to which Defence has made progress on its reform agenda since 2003.

There is little doubt that a considerable amount of work has been undertaken by the Department to remediate and reform its financial management practices. Similarly, Defence and the Defence Materiel Organisation (DMO) have worked hard to implement the recommendations of the *Defence Procurement Review 2003* (the Kinnaird Review). The Committee commends Defence's senior leadership team and their commitment to driving these reforms through the Department. However, the job is not yet complete. Three key areas have emerged from this inquiry. First, Defence must now undertake a comprehensive assessment of the effectiveness of the Kinnaird reforms including whether the full intent of the Kinnaird Review (i.e., to make the DMO a more business-like, outcomes-focussed organisation) has been realised. And, to that end, the Committee welcomes the Defence Procurement and Sustainment Review which is currently underway.

Second, the Department must demonstrate a greater commitment to measuring and monitoring outcomes. This involves developing techniques to evaluate the outcomes of its reform agenda. Third, the Department must make full use of the

Major Projects Report as a vehicle which can improve transparency and accountability. This Report, which will be reviewed by this Committee and other relevant committees of the Parliament on a regular basis, provides a unique opportunity to continuously scrutinize how Defence dollars are being spent and whether value for money is being achieved on behalf of the Australian public.

This was a long inquiry. It began in March 2006 and traversed two parliaments. I am therefore grateful for the work of the Members of the Defence Sectional Committees of both the 41<sup>st</sup> Parliament and the 42<sup>nd</sup> Parliament.

I would also like to thank the individuals and organisations who gave up their time to provide written submissions and oral evidence to the Committee.


It has been claimed in the past that deficiencies with the Department of Defence have impacted little on the Australian Defence Force's operational activities. However, more recently the Secretary of the Department of Defence, Mr Nick Warner conveyed the following caution "...unless the underlying weaknesses of Defence are fixed, over time our ability to deploy successfully will slowly but surely diminish".<sup>1</sup> The Committee takes this warning very seriously. The Committee will therefore continue to devote time to ensuring that Defence maintain its commitment to a robust and efficient financial management framework and achieving best practice in the procurement of Defence equipment.

Sharon Grierson MP  
Committee Chair

---

1 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008, p 2.





## Membership of the Committee (41st Parliament)

Chair	Mr Phil Barresi MP (Chair) (from 6/2/07)	
	Hon Tony Smith MP (Chair) (from 9/2/06 to 6/2/07)	
	Hon Bob Baldwin MP (until 7/2/06)	
Deputy Chair	Ms Sharon Grierson MP (Deputy Chair)	Mr Ken Ticehurst (until 29/5/08)
Members	Hon Bronwyn Bishop MP (from 16/8/05)	Senator Mark Bishop (from 11/5/06)
	Mr Russell Broadbent MP	Senator Gary Humphries
	Ms Anna Burke MP (until 12/9/05)	Senator John Hogg
	Dr Craig Emerson MP (from 12/9/05)	Senator Andrew Murray
	Ms Jackie Kelly MP	Senator Grant Chapman (from 23/3/07)
	Dr Dennis Jensen MP (from 29/5/06)	Senator Claire Moore (until 11/5/06)
	Ms Catherine King MP	Senator Andrew Murray
	Mr Andrew Laming MP	Senator Fiona Nash (until 23/3/07)
	Hon Alexander Somlyay MP (until 16/8/05)	Senator the Hon Nigel Scullion (until 16/8/05)
	Mr Lindsay Tanner MP	Senator John Watson

## Members of the Sectional Committee (41st Parliament)

Chair Mr Phil Barresi MP (Chair)

Deputy Chair Ms Sharon Grierson MP (Deputy Chair)

Members Hon Bronwyn Bishop MP Senator Mark Bishop  
Dr Dennis Jensen MP Senator John Hogg  
Hon Jackie Kelly MP  
Mr Lindsay Tanner MP

## Committee Secretariat (41st Parliament)

Secretary Mr Russell Chafer

Inquiry Secretary Dr Kris Veenstra


Ms Susan Cardell

Ms Bronwen Jagers

Ms Julia Searle

Office Manager Ms Frances Wilson

Administrative Officer Ms Emily Shum



## Membership of the Committee (42nd Parliament)

Chair Ms Sharon Grierson MP (Chair)

Deputy Chair Mr Petro Georgiou MP  
(Deputy Chair)

Members	Hon Bob Baldwin MP	Senator Mark Bishop
	Hon Arch Bevis MP	Senator Sue Boyce (from 1/7/08)
	Mr David Bradbury MP	Senator David Bushby (from 1/7/08)
	Mr Mark Butler MP	Senator Grant Chapman
	Ms Catherine King MP	Senator John Hogg
	Mr Scott Morrison MP	Senator Kate Lundy
	Mr Shayne Neumann MP	Senator Andrew Murray (until 30/6/08)
	Mr Stuart Robert MP	Senator John Watson (until 30/6/08)

## Members of the Sectional Committee (42nd Parliament)

Chair Ms Sharon Grierson MP (Chair)

Deputy Chair Mr Petro Georgiou MP (Deputy Chair)

Members Hon Bob Baldwin MP Senator Mark Bishop  
Hon Arch Bevis MP Senator John Hogg  
Mr Stuart Robert MP

## Committee Secretariat (42nd Parliament)

Secretary Mr Russell Chafer

Inquiry Secretary Dr Kris Veenstra

Administrative Officer Ms Naomi Swann



## Terms of reference

### **Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation**

The Joint Committee of Public Accounts and Audit shall inquire into and report on progress in implementing systematic reforms in the areas of financial reporting and equipment acquisition at the Department of Defence and the Defence Materiel Organisation (DMO), as identified in ANAO financial and performance audits, the Defence Procurement Review 2003 (the Kinnaird Review) and the Senate Foreign Affairs, Defence and Trade References Committee's 2003 *Report on the Inquiry into Materiel Acquisition and Management in Defence*, including the following:

- Progress in implementing Defence's financial remediation plans, relative to international best practice in these areas, and recommend any further measures that can be adopted;
- Progress in implementing the Kinnaird Reforms, relative to international best practice in these areas, and recommend any further measures that can be adopted;
- Review Australia's relative achievements in procurement and financial reform relative to international best practice in these areas of defence administration; and
- Assess progress in Defence's adoption of international business accounting standards relative to international best practice in this area of defence administration.

## List of abbreviations

AASB	Australian Accounting Standards Board
ADF	Australian Defence Force
AEIFRS	Australian Equivalents to International Financial Reporting Standards (see also IFRS and AIFRS)
AIFRS	Australian Equivalents to International Financial Reporting Standards (see also AEIFRS and IFRS)
AGAAP	Australian Generally Accepted Accounting Principles
AIC	Australian Industry Capability
AII	Australian Industry Involvement
ANAO	Australian National Audit Office
APS	Australian Public Service
AVO	Australian Valuation Office
CCDG	Chief Capability Development Group
CDAF	Capability Development Advisory Forum
CDF	Chief of the Defence Force
CDG	Capability Development Group
CEO	Chief Executive Officer
CFO	Chief Finance Officer
CJOPS	Chief of Joint Operations

COTS	Commercial-off-the-shelf
DBIB	Defence Business Improvement Board
DMO	Defence Materiel Organisation
DMR	Defence Management Review
DOD	Department of Defense (US)
DPR	Defence Procurement Review
EO	Explosive ordnance
ESM	Electronic surveillance measures
EVMS	Earned Value Management System
FRP	Financial Remediation Project
FSPB	Financial Statements Project Board
IFRS	International Financial Reporting Standards (see also AEIFRS and AIFRS)
JCPAA	Joint Committee of Public Accounts and Audit
JSCFADT	Joint Standing Committee on Foreign Affairs, Defence and Trade
MOD	Ministry of Defence (UK)
MOTS	Military-off-the-shelf
SADI	Skilling Australia's Defence Industry
SCAs	Supply Customer Accounts
SDSS	Standard Defence Supply System
TLS	Through-life-support
UK NAO	United Kingdom National Audit Office
US GAO	United States Government Accountability Office



## List of findings and recommendation

Since the commencement of this inquiry a substantial amount of work has been conducted by the Department of Defence to address major concerns identified in the 2003 Senate Foreign Affairs, Defence and Trade References Committee report into *Materiel acquisition and management in Defence*, the *Defence Procurement Review 2003* and financial and performance audits of the Australian National Audit Office. Significant progress has been made in a number of areas, most notably in remediating its financial statements position, and in implementing the Kinnaird recommendations. However, concerns remain in a number of areas. These concerns are set out in the Committee findings listed below in the following categories: *The Kinnaird Reforms; Measuring Outcomes; and Transparency and Accountability – the Major Projects Report*.

### Committee findings

#### The Kinnaird Reforms

- **Implementation of the Kinnaird Review recommendations is all but complete, however, a process for determining the effectiveness of the Kinnaird reforms is in its infancy.**
- **The early phases of the capability development and acquisition cycle remain a critical area for the Department of Defence and the DMO. The clear articulation and communication of requirements is vital to that process. Defence must retain a strong focus on the leadership of the Capability Development Group and resource the area appropriately.**
- **Progress on the implementation of Recommendation 4 of the Kinnaird Review remains deficient and should be attended to as a matter of priority.**



- 
- Ongoing monitoring of the Kinnaird reforms by a body such as the Defence Procurement Advisory Board or its equivalent is critical to determining the ultimate success of the implementation of the Review's recommendations.

## Measuring Outcomes

- Insufficient attention has been paid to developing techniques by which the status of the reform agenda can be measured.
- Priority should be given to developing metrics to gauge the impact of the Kinnaird reforms in terms of initiating and maintaining cultural change across the Department. In particular, these metrics should assess the degree to which the DMO has become a more business-like and outcomes-focussed organisation.
- The Department's large investment in financial training should be accompanied by the development of metrics to evaluate and monitor the effectiveness of this investment. This evaluation should go beyond simply reporting the number of personnel who have undergone financial skills training and should also assess attitudes to financial management across the Department.
- A definitive statement on the status of each individual remediation plan should be made publicly available.

## Transparency and Accountability – Major Projects Report

- Oversight of the reforms undertaken by Defence is not a straightforward process. While the Major Projects Report represents a significant step forward in this respect, the Committee believes that more can be done to improve transparency and accountability across the Defence portfolio.
- Procedures and processes for documenting lessons learnt on all major projects are patchy and inconsistent. Lessons learnt should be accessible, consistent in their format, and communicated effectively.
- Inconsistent and ambiguous use of important terms including but not limited to 'off-the-shelf', 'cost blow out', 'lead customer', 'legacy project', 'pricing', 'pre-Kinnaird', 'post-Kinnaird' as well as terms denoting 'stages of acceptance' and 'release' continue to cause problems. The Committee urges Defence to standardise its procurement-related terminology.

- Any project deemed appropriate to be included in the Major Projects Report should continue to be reported on until full operating capability is achieved.
- It is critical that the Major Projects Report be publicly scrutinized by the relevant Committees of Parliament on an annual basis to ensure that the true intent of the report (i.e., to identify and remedy problems expeditiously) is preserved.

## Recommendation

*The Department of Defence address the Committee's findings above and provide an update to the Committee at a public hearing to be held 12 months from the tabling of this report.*



# Executive summary

## Introduction

In March 2006, the Joint Committee of Public Accounts and Audit (JCPAA) resolved to conduct an inquiry into financial reporting and equipment acquisition at the Department of Defence and the Defence Materiel Organisation (DMO).

Defence is an immense and complex portfolio. Departmental funding for Defence in 2008-09 represents 1.8 per cent of GDP and the DMO currently manages 236 major projects (valued at over \$20 million each) and 180 minor projects. While few would argue that operationally, the effectiveness of the Australian Defence Force is second-to-none, the Department of Defence has had a problematic history around financial reporting and equipment acquisition. Problems with financial reporting within Defence culminated in the Australian National Audit Office (ANAO) expressing an inability to form an opinion on Defence's financial statements for the years 2003-04 and 2004-05. Additionally, protracted problems with a number of major acquisition projects at the DMO are well documented and widely known as a result of a series of critical ANAO performance audits. The Department of Defence has been under intense pressure to make improvements as a result of these difficulties.

In 2003, two significant Defence-related reports were published: the *Senate Foreign Affairs, Defence and Trade References Committee Report into Materiel Acquisition and Management in Defence*; and the *Defence Procurement Review* (the Kinnaird Review). The objective of the Senate inquiry was to take a snapshot of progress since the restructure of the DMO that came about as a result of the 2000 White Paper. The purpose of the Kinnaird Review was to examine the processes around developing and maintaining capability. The Kinnaird Review set out a number of recommendations addressing each stage of the capability acquisition cycle, making explicit the imperative for the DMO to become a more outcomes-focussed organisation. In 2003, the Department of Defence also instituted a comprehensive financial remediation program to address issues related to financial management.

Significant resources have been expended to address financial management issues and to implement the recommendations of the Kinnaird Review. The primary

objective of this inquiry was to examine progress made since the publication of the Senate report and the Kinnaird Review and to identify remaining challenges.

The inquiry has seen a change of Government and subsequent announcements about a new Defence White Paper and a series of companion reviews. The Government is also currently undertaking a Defence Procurement and Sustainment Review chaired by Mr David Mortimer AO.

History advises that the Parliament must be vigilant in monitoring the business-end of Defence - this inquiry is part of that process.

## Financial reform

A considerable amount of work has been undertaken by the Department in the form of a comprehensive remediation program to address the audit findings from the 2003-04 and 2004-05 financial years. Sixteen remediation plans put in place as part of that program are largely complete, an effective financial management framework is in place and the relationship between the ANAO and Defence on financial issues appears to be open and proactive.

The Committee was impressed with the progress that has been made on remediating the Department's financial management issues. The Department of Defence is working hard to remove uncertainty around the reported balance of Inventories - General. The Committee makes two findings on the basis of the evidence reported on in this Chapter. The first is in response to a lack of consistency in reporting progress on and/or completion of its remediation activities. The second is related to how the Department will be able to determine the ultimate effectiveness of its investment in financial skills training.

## The Kinnaird reforms

The authors of the Kinnaird Review stressed the need for change. More specifically, they advocated rapid and fundamental change to reshape systems, structures and organisational culture. There are two key elements to consider when examining the changes that have taken place as a result of the Kinnaird Review. The first is the implementation of the recommendations *per se*. The second is whether the true intent of the reforms is being realised as a result of the implementation of those recommendations.

The evidence gathered during the inquiry demonstrates that the Kinnaird Review recommendations, where agreed, have been largely implemented to reshape systems and structures. One important outcome of the Kinnaird Review was the establishment of a single point of accountability for capability definition and assessment, and the work of the Capability Development Group (CDG) is central

---

to the success of the capability development and acquisition process. The importance of clearly defined and articulated requirements and effectively managing high levels of technical risk cannot be overstated. In recognition of this, the Committee reiterates in its findings the significance of retaining strong leadership of the CDG as envisaged in the Kinnaird Review and the need for appropriate resourcing.

Determining progress of the implementation of the Kinnaird Review recommendations is relatively straightforward. However, measuring the effectiveness of the resulting reforms is a somewhat more difficult and ongoing task. The Kinnaird Review recommended that a body be set up to advise and support the DMO and report progress of the implementation of the recommendations. To that end, the Defence Procurement Advisory Board was established. From evidence presented to the Committee it appears while the Board has overseen implementation of the recommendations, the job of measuring the effectiveness of the reforms has not yet begun in earnest. Of particular interest is the impact of the reforms not only on actual outcomes (i.e., improvements in cost overruns, schedule and delivery) which the Committee will monitor through its routine reviews of ANAO performance audits but also on the organisational culture of the DMO (i.e., is the DMO a more business-like, outcomes-focused organisation?). The Committee makes one finding related to an outstanding aspect of the implementation of the Kinnaird recommendations. The others are related to determining the ultimate effectiveness of the Kinnaird reforms.

## The case studies

The inquiry's two case studies, the Fast Frigate Guided (FFG) Upgrade Project and ARH Project Air 87 ('the Tigers') illustrate the type of issues that have previously been identified by ANAO performance audits and other critical Defence reviews. Poor project management and inventory management practices, non-enforcement of contract provisions, risk allocation, training and retaining personnel, documenting lessons learnt, and the need for cultural change were all again identified as key concerns.

Defence is well-acquainted with the issues that were raised over the course of this inquiry. It is now well known that careless inventory management impacts significantly on the financial reporting of the Department, project management practices are firmly in the spotlight, and the appropriate allocation of risk between industry and Government is a priority. The Committee will be vigilant in keeping these matters under review as performance audits of post-Kinnaird projects start to emerge.

The need for cultural change across the Department of Defence has been expressed *ad nauseam* over a number of years in a number of contexts. Yet, to date

no systematic and explicit attempt to measure and monitor Defence culture has been put in place. The Committee's findings reflect the need for Defence to pay significantly more attention to monitoring such change.

Despite its intensive campaign to professionalise its workforce, finding and keeping appropriately-trained staff remains a major challenge for the DMO. Challenges around the recruitment and retention of appropriately trained personnel make the collection and communication of corporate knowledge all the more critical. In its findings, the Committee reasserts the need for Defence to commit to developing a comprehensive formal process for documenting the lessons learnt on acquisition projects.

## Major Projects Report

The absence of clear, consistent information from which to assess the progress of major acquisition projects has been a major concern for a number of years. This deficiency led the Committee to unanimously recommend during the course of the inquiry that the Auditor-General receive funding to produce an annual report on the progress of major acquisition projects.

The Major Projects Report, for which the ANAO has been allocated \$1.5 million from 2009-10 onwards, follows similar reporting models to those in the United States but more particularly, the United Kingdom. The DMO will prepare base material on the status of each included project and the ANAO will conduct an overview of that material.

The Major Projects Report provides an opportunity to increase the transparency of Defence projects. The Committee's findings reflect the importance of maintaining a holistic approach where projects are monitored from beginning to end (i.e., from contract signature to the achievement of capability). The Committee is confident this should, over time, contribute to a comprehensive and timely understanding of where projects succeed and where they fail. The Committee also believes that in articulating its concern about the use of ambiguous and inconsistent terminology such as 'military-off-the-shelf' and 'cost blow out', this will motivate the Department to carefully reconsider how these terms are to be understood consistently by the Australian public, the Parliament, industry and across the Department of Defence itself.

The Committee reasserts its steadfast commitment to its ongoing role, and that of other Parliamentary committees, in monitoring and reviewing Defence acquisition practices. The Committee will be alert to any attempts made to diminish the scope and depth of the Major Projects Report.

## Conclusion

Since 2003, Defence has made significant progress toward improving the framework and processes underpinning the administration of its financial affairs. Similarly, the recommendations of the Kinnaird Review have been largely implemented. The Committee is pleased with this progress but warns Defence against complacency.

Over a number of years, this and other Parliamentary committees have expressed a great deal of frustration about the less than positive outcomes on a number of significant Defence acquisition projects and about the lack of disclosure around what went wrong with those projects, who was responsible and what has been learned to avoid problems in the future.

The Committee hopes that the Kinnaird reforms once realised will reduce the likelihood of cost overruns and schedule slippages. Similarly, the Committee is hopeful that the continuous, comprehensive and transparent monitoring that underpins the Major Projects Report in conjunction with the routine performance audits conducted by the ANAO, will strengthen the Parliament's capacity to identify problems early. This should also lessen the likelihood of future inquiries being referred to Parliamentary committees.

That said, the Major Projects Report is not a panacea. Given the magnitude and significance of the Department of Defence to the security of all Australians, the Committee is anxious to ensure that the Department of Defence does not 'drop the ball' either in terms of its financial reporting obligations or the management of equipment acquisitions.





## Introduction

### Background

- 1.1 On 1 March 2006, the Joint Committee of Public Accounts and Audit (JCPAA) resolved to conduct an inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation. Full terms of reference are at page *xiv*.
- 1.2 This inquiry arose primarily from the Committee's statutory obligation to examine all reports of the Auditor-General.
- 1.3 In Audit Report No. 21, 2004-05, entitled *Audits of Financial Statements of Australian Government Entities for the Period Ended 30 June 2004*, tabled in January 2005, the Australian National Audit Office (ANAO) identified a series of significant 'audit scope limitations'<sup>1</sup> on key financial systems within Defence. These limitations resulted in the ANAO expressing an inability to form an opinion on the Department of Defence's financial statements for the period 2003-04. The ANAO had never before expressed an inability to form an opinion on a

---

1 "Limitations on the scope of an audit arise when sufficient appropriate audit evidence does not exist to support a reported balance." See ANAO Audit Report No. 21, 2005-06 *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2005*, p 95.

government entity's financial statements.<sup>2</sup> The then Secretary of Defence, was also unable to attest that the financial statements for that period were 'true-and-fair'.<sup>3</sup>

- 1.4 In the following year (2004-05), again, the Secretary of Defence and Acting Chief Finance Officer could not attest that the overall financial statements were true and fairly stated and the ANAO again expressed a qualification as an inability to form an opinion.<sup>4</sup>
- 1.5 These qualifications follow a history of significant internal control issues which cast doubt on the accuracy of Defence's financial statements.<sup>5</sup>
- 1.6 In its Report 404, *Review of Auditor-General's Reports 2003-04 Third and Fourth Quarters; and First and Second Quarters of 2004-05*, the JCPAA commented that it would monitor the Department's progress in improving its financial status. The Committee also foreshadowed that this monitoring may include a more detailed Committee inquiry on Defence financial management.<sup>6</sup>
- 1.7 In addition to monitoring Defence's financial management, the ANAO, through its performance audits, has identified a series of matters impacting on the efficient and effective delivery of defence capability requirements.
- 1.8 The ANAO has conducted a large number of performance audits into Defence-related matters. The following performance audits were of particular interest to the Committee:
  - Audit Report No. 5, 2004-05, *Management of the Standard Defence Supply System Upgrade*;
  - Audit Report No. 45, 2004-05, *Management of the Selected Defence System Program Offices*;

---

2 Joint Committee of Public Accounts and Audit, *Report 404 Review of Auditor-General's Reports 2003-2004 Third & Fourth Quarters; and First and Second Quarters of 2004-2005*, p 142.

3 Australian National Audit Office, Audit Report No. 21, 2004-05, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June, 2004*, p 101.

4 Australian National Audit Office, Audit Report No. 21, 2005-06, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June, 2005*, p 95.

5 Senate Foreign Affairs, Defence and Trade Committee, *Annual reports (No. 1 of 2007)*, p 8.

6 Joint Committee of Public Accounts and Audit, *Report 404 Review of Auditor-General's Reports 2003-2004 Third & Fourth Quarters; and First and Second Quarters of 2004-2005*, p 166.

- Audit Report No. 36, 2005-06, *Management of the Tiger Armed Reconnaissance Helicopter Project-Air 87*;
- Audit Report No. 10, 2006-07, *Management of the Standard Defence Supply System Remediation Programme*; and
- Audit Report No. 11, 2007-08, *Management of the FFG Capability Upgrade*.

1.9 The quote from the ANAO below summarises the issues that have typically, though not universally, been associated with Defence acquisition projects:

...outcomes have not always been as positive as expected. Recent performance audits into acquisition projects have identified significant weaknesses in project planning, including risk identification and management, as well as project costing issues. Some projects have suffered cost overruns or had scope limitations imposed for budget management reasons, and have experienced delays in implementation. Poor contract management practices have also resulted in inadequate identification and management of contractor delivery problems. Audits also identified a need to strengthen overall project monitoring and record keeping.<sup>7</sup>

## Previous reviews

- 1.10 This is not the first time management of Defence equipment acquisition has come under scrutiny. In March 2003, the Senate Foreign Affairs, Defence and Trade References Committee tabled a report entitled *Material acquisition and management in Defence*.
- 1.11 This Senate inquiry was conducted in light of a history of troubled acquisition projects across the Defence portfolio and at a time of structural reform within Defence that included the creation of the Defence Materiel Organisation (DMO).<sup>8</sup>
- 1.12 The Senate Committee published a number of findings and recommendations and set benchmarks against which to assess further performance of the DMO. Of particular relevance to the JCPAA were

---

<sup>7</sup> Australian National Audit Office, sub 3, p 4.

<sup>8</sup> Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p xix.

two recommendations directed to the Auditor-General. The first requesting the Auditor-General to conduct a cultural audit (i.e., an audit of the existing culture to identify strategies for cultural change) of the DMO.<sup>9</sup> The second requested the Auditor-General to produce an annual report on progress in major defence projects to improve visibility to the Parliament.<sup>10</sup>

- 1.13 In December 2002, the Government initiated a separate review of Defence procurement. The aim of this review, the *Defence Procurement Review* (also known as the 'Kinnaird Review') was to review the problems associated with major Defence acquisition projects and to identify further improvements that could be made across the whole defence capability management process. The report of the Kinnaird Review was published in August 2003.<sup>11</sup> The Kinnaird Review is discussed in more detail in Chapter 3 of this report.

## Programs of reform

### Financial remediation

- 1.14 Since 2003, the Department of Defence has directed significant resources to a comprehensive financial remediation program to reform Defence financial management.
- 1.15 The financial remediation program consists broadly of 16 remediation plans to address the adverse audit findings of the ANAO. These plans included the establishment of a Financial Controls Framework to standardise and document the way Defence meets its financial obligations and an extensive up-skilling/training regime for Defence personnel. Defence also developed a series of technical papers to maximise the likelihood that the Auditor-General would be able to form an opinion on the 2005-06 financial statements and to address the issues raised in the adoption of the Australian Equivalents to International Financial Reporting Standards (AEIFRS).

---

9 Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p 51.

10 Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p 79.

11 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*.

- 1.16 The financial remediation program is examined in more detail in Chapter 2 of this report.

## Kinnaird reforms

- 1.17 The Government announced in September 2003 that it had broadly accepted the findings of the Kinnaird Review.<sup>12</sup>
- 1.18 Key reforms, outlined in the Defence submission, include the following:
- the establishment of Capability Development Group to strengthen the capability and assessment process;
  - a strengthened 'two pass' process for new acquisitions;
  - the establishment of costing centres in Defence and the Department of Finance and Administration to provide a quality assurance role;
  - the establishment of the DMO as a prescribed agency;
  - the establishment of a high-level advisory board;
  - consideration of the remuneration and tenure of appropriately skilled project managers; and
  - extending the role of Project Governance Boards to advise CEO DMO on through-life support issues.<sup>13</sup>
- 1.19 According to Defence's Portfolio Budget Statements for the year 2007-08, implementation of the Kinnaird Review recommendations is 85 per cent complete.<sup>14</sup>
- 1.20 However, the following quote from an industry representative illustrates an important point:
- ...organisational and administrative changes recommended by the Kinnaird Review have largely been put in place. What is not yet clear is whether the associated cultural and behavioural changes are proceeding apace. It is the latter changes that ultimately will determine whether the process overall produces better outcomes.<sup>15</sup>

---

12 Department of Defence, sub 4, p 83.

13 Department of Defence, sub 4, pp 83-84.

14 Department of Defence, *Portfolio Budget Statements 2007-08*, p 206.

15 Raytheon Australia Pty Ltd, sub 5, p 8.

## Purpose of inquiry

- 1.21 It is five years since the commencement of the financial remediation program, the release of the Kinnaird Review recommendations and the Senate Foreign Affairs, Defence and Trade References Committee report into materiel acquisition and management in Defence.
- 1.22 While there has been some ongoing monitoring of Defence's remediation program and the Kinnaird reforms, the purpose of this inquiry was to take a more comprehensive look at the progress and key achievements in implementing the financial remediation activities and Kinnaird reforms.

## Further developments

- 1.23 Since the commencement of this inquiry there has been a change of Government which has been accompanied by a number of announcements related to the management of the Department of Defence. These announcements include the development of a new White Paper which will provide a long-term plan for the whole Australian Defence enterprise and a series of White Paper Companion Reviews.<sup>16</sup>
- 1.24 On 7 May 2008, the Hon Greg Combet MP, Parliamentary Secretary for Defence Procurement, also announced a review of Defence procurement and sustainment.
- 1.25 The Committee welcomes these developments.

## Structure of report

- 1.26 The report is comprised of five chapters. Chapters 2 and 3 document the progress made since the implementation of the financial remediation program and the Kinnaird reforms respectively and outlines the current status of those reform agendas. Chapter 4 outlines two case studies examined by the Committee and highlights the key concerns of the Committee. Chapter 5 provides an outline of the Major Projects Report.

---

16 See Department of Defence, *Portfolio Budget Statements 2008-09*, p 35 for further detail.

- 1.27 The Committee makes a number of findings on the basis of the evidence it received during the inquiry. These findings, together with a recommendation are set out in full at page *xvii*.

## **Conduct of inquiry**

- 1.28 The inquiry's terms of reference and an invitation for written submissions were advertised in the national press on 18 March 2006. The Committee also wrote to a number of organisations seeking submissions.
- 1.29 The inquiry received twenty submissions and fifteen exhibits. Lists of submissions and exhibits received can be found at Appendices A and B respectively.
- 1.30 The Committee held public hearings, in-camera hearings and private briefings in Canberra and in Perth. A list of the hearings can be found at Appendix C and a list of inspections at Appendix D.

## Financial reform

### Background

- 2.1 The Department of Defence is the largest of all Australian Government Departments both in budgetary and personnel terms. Defence's total departmental funding in 2008-09 is \$22,690.3 million. This represents 1.8 per cent of GDP.<sup>1</sup>
- 2.2 Defence's total workforce is forecast to be 90,581 in 2008-09. This comprises 54,747 permanent Australian Defence Force (ADF) members, 19,915 Reservists, 14,754 civilian staff and 1,165 professional service providers.<sup>2</sup>
- 2.3 At the end of each financial year, the Chief Executive of the Department of Defence, in common with the Chief Executives of other Australian Public Service (APS) agencies, is required to prepare financial statements that give a true and fair presentation of the financial position and performance of the Department. These statements must comply with the *Financial Management and Accountability Act 1997* (FMA Act), Accounting Standards and other mandatory financial reporting requirements.
- 2.4 On the basis of an audit conducted in accordance with the Australian National Audit Office Auditing Standards, the Auditor-General is then

---

1 Department of Defence, *Portfolio Budget Statements 2008-09*, p 5.

2 Department of Defence, *Portfolio Budget Statements 2008-09*, p 61.



required to express an audit opinion on those financial statements. This opinion may be either unqualified<sup>3</sup> or qualified<sup>4</sup>.

- 2.5 As outlined in Chapter 1, neither the Department Executive nor the Auditor-General were able to verify the accuracy of Defence's financial statements for the years 2003-2004 and 2004-2005. In the same years, the opinion of the Auditor-General was qualified, expressed as an inability to form an opinion.<sup>5</sup>
- 2.6 Defence's inability to meet the requirements of the FMA Act 1997 in 2003-04 and 2004-05 followed a well-documented history of uncertainty in Defence's internal control environment and ongoing qualifications in their financial statements since 2001.<sup>6</sup>
- 2.7 In 2005-06, for the first time in two years, the Secretary and Chief Finance Officer of Defence were able to sign Defence's financial statements on an 'except for' basis.<sup>7</sup> The Auditor-General issued a qualified opinion concluding that Defence's 2005-06 financial statements were true and fair with the exception of Inventories-General and Repairable Items.<sup>8</sup>
- 2.8 In 2006-07, the Chief Finance Officer again certified Defence's financial statements for the year 2006-07 on a 'true and fair except for' basis<sup>9</sup> and
- 

3 "An unqualified audit report is provided when the financial statements, in all material respects, give a true and fair view of the matters required by applicable Accounting Standards and other mandatory professional reporting requirements in Australia, and the FMOs, so as to present a view which is consistent with the entity's financial position, its financial performance, and its cash flows." Australian National Audit Office, Audit Report No. 15 2006-2007, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 41.

4 Qualified audit opinions may be expressed in three ways: an *except for opinion*; an *inability to form an opinion*; or, an *adverse finding*. See Australian National Audit Office, Audit Report No. 15 2006-2007, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 41.

5 "An inability to form an opinion - commonly referred to as a disclaimer, is expressed when a scope limitation exists and sufficient appropriate audit evidence to resolve the uncertainty resulting from the limitation cannot reasonably be obtained; and the possible effects of the adjustments that might have been required, had the uncertainty been resolved, are of such a magnitude, or so pervasive or fundamental, that the auditor is unable to express an opinion on the financial report taken as a whole." See Australian National Audit Office, Audit Report No. 15, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 41.

6 Senate Foreign Affairs, Defence and Trade Committee, *Annual reports (No 1 of 2007)*, p 8.

7 See Australian National Audit Office, Audit Report No. 15 2006-07, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 99.

8 Australian National Audit Office, Audit Report No. 15 2006-07, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 99.

9 Department of Defence, *Annual Report 2006-2007*, p 32.

on 17 October 2007, the Auditor-General issued a qualified opinion, consistent with the view of the Secretary and the Chief Finance Officer, that Defence's financial statements were true and fair with the exception of Inventories – General. This qualification is related to uncertainty around the reported balance of Inventories – General due to pricing and system-related issues.<sup>10</sup>

- 2.9 These improvements in financial management at Defence came about as a result of a number of important remediation strategies that had been put into place in 2003-2004.
- 2.10 The Committee examined the remediation program and the progress made on each of the remediation plans. The Committee also examined financial management at the Department of Defence compared to other Defence organisations overseas.

## The remediation program

- 2.11 In 2003-2004, Defence commenced a comprehensive financial remediation program. This program is comprised primarily of a series of remediation plans and includes the development of a Financial Controls Framework and an extensive financial training regime as well as the development of a series of position papers on key accounting issues.
- 2.12 In November 2003, a Financial Statements Project Board (FSPB) was established specifically to drive the necessary financial remediation and report to Government on its progress. The FSPB was replaced by the Financial Management and Control Committee that monitors financial remediation and financial controls within Defence.<sup>11</sup>

## Remediation plans

- 2.13 Defence was required to address 141 ANAO audit findings. Ninety-five of those audit findings related to 2003-04 (this included 38 from previous years) and 46 audit findings related to 2004-05.<sup>12</sup>

---

10 Australian National Audit Office, Audit Report No. 18 2007-08, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2007*, p 91.

11 Department of Defence, sub 4.7

12 See Department of Defence, sub 4, p 28 for detail on these audit findings.

- 2.14 To that end, Defence developed a series (16) of remediation plans. Three plans (numbered G1 to G3) relate to general financial issues and thirteen plans (numbered S1 to S13) relate to specific functional areas.
- 2.15 Up to and including the release of Defence's *Portfolio Additional Estimates Statements 2006-07*, the Department reported summary information on each plan, activities undertaken and major outcomes in a tabular format. The most recent of those tables is reproduced in the following pages.<sup>13</sup>

Remediation plan	Activity	Major outcomes
<b>G1: Financial Reporting Framework</b>		
<p>The Defence financial management system has been subject to many Australian National Audit Office (ANAO) findings over a period of years.</p> <p>The aim of the remediation activity is to provide a robust control regime for the financial management of Defence business. The financial controls framework will draw together, in a structured and integrated fashion, all of the control elements necessary to build a best practice financial management environment for Defence. It will encompass the standardisation of financial processes, reporting and data requirements, a financial staff certification strategy and a change management program. The remediation plan is Australian equivalents to International Financial Reporting Standards (AIFRS) compliant.</p> <p>Accountable officer: Chief Finance Officer</p>	<p>Develop and embed a comprehensive Defence Financial Controls Framework that includes:</p> <ol style="list-style-type: none"> <li>Establishing the elements of the financial controls framework;</li> <li>Assigning responsibility to Group Heads to implement the financial controls framework;</li> <li>Implementing standardised processes and practices; and</li> <li>Establishing business skilling and competency assessment.</li> </ol>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>Identification of key controls and risks across Defence's balance sheet and document key processes and procedures;</li> <li>Financial training has been strengthened; and</li> <li>The substantive testing of employee records completed, 80 per cent of the leave controls testing program completed and analytical reviews commenced.</li> </ol> <p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>Complete the identification of all risks and the assessment of the materiality of these risks;</li> <li>Complete the testing of leave controls and analytical reviews;</li> <li>Continue the implementation of a comprehensive financial management and controls framework for Defence which embeds best practice financial controls and ensures conformance and performance; and</li> <li>Continue to develop and implement tailored financial management training, maintaining the framework, and a robust financial risk management regime.</li> </ol>

<sup>13</sup> Department of Defence, *Portfolio Additional Estimates Statements 2006-07*, pp 112-127.

Remediation plan	Activity	Major outcomes
<p><b>G2: Improving the ANAO Annual Audit Process</b></p> <p>Having a clear agreement with the ANAO on timelines, methodologies and expectations of deliverables from both parties is crucial to the finalisation of the annual financial statements.</p> <p>Accountable officer: First Assistant Secretary Financial Services</p>	<p>Establish an accountable officer to manage audit activities between Defence and the ANAO. Key tasks include:</p> <ul style="list-style-type: none"> <li>a. Negotiating an engagement plan;</li> <li>b. Agreeing to a consistent approach for terminology, quality and format of responses; and</li> <li>c. Establishing comprehensive procedures for quality assurance and clearing audit findings.</li> </ul>	<p><b>Achieved in 2005-06:</b></p> <ul style="list-style-type: none"> <li>a. Defence Audit Liaison Officers network was established;</li> <li>b. A series of position papers on accounting treatment issues was released, and comprehensive procedures for quality assurance and clearing audit findings were established; and</li> <li>c. Regular meetings were held with ANAO staff to improve the relationship between Defence and the ANAO.</li> </ul> <p><b>Planned for 2006-07:</b></p> <ul style="list-style-type: none"> <li>a. Establish a clear agreement with the ANAO on timeline, methodologies and expected deliverables of both parties for the 2006-07 audit;</li> <li>b. Clear remaining ANAO findings from 2004-05 and earlier;</li> <li>c. Commence remediation of 2005-06 audit findings; and</li> <li>d. Continue to improve the relationship between Defence and the ANAO.</li> </ul>

Remediation plan	Activity	Major outcomes
<p><b>G3: Financial Management and Systems Training – Financial and Business Management</b></p> <p>A consistent theme in the ANAO audit findings is the requirement for enhanced skills in the execution of financial management procedures and adherence to approved procedures in the use of Defence corporate information technology systems. The ANAO made some targeted recommendations with regard to enhanced training to address the lack of knowledge in accounting, financial and business management (ROMAN), transactor knowledge (PMKeyS), and the Standard Defence Supply System (SDSS). These are complemented by a number of other observations about failures in the application of policy and procedures. Accountable officers: Chief Finance Officer and Director-General Defence Education and Training Development</p>	<p>Develop, conduct and deliver business capability training to improve officers' underpinning knowledge and skills:</p> <ul style="list-style-type: none"> <li>a. Accrual accounting;</li> <li>b. Diploma of Government (Financial Management); c. Graduate Certificate in Professional Management (Finance); and</li> <li>a. Financial management processes for Senior Executive Service and Executive Level 1 and 2 officers and ADF equivalents.</li> </ul>	<p><b>Achieved in 2005-06:</b></p> <ul style="list-style-type: none"> <li>a. A new set of three induction/introductory level financial management courses was developed and rolled out, including regional delivery across Australia;</li> <li>b. Financial management training for the Senior Leadership Group (Service and civilian) continued to be delivered; and</li> <li>c. Three financial management courses were developed and delivered to Senior Officers at the Executive Level 1 and 2 (and military equivalent) levels. These programs included tailoring to meet specific Group requirements as well as being rolled out to meet regional needs.</li> </ul> <p><b>Planned for 2006-07:</b></p> <ul style="list-style-type: none"> <li>a. Finance and Business Training: Financial Delegations eLearning course developed;</li> <li>b. Complete development of Certificate IV level competency aligned courses and release during 2006-07;</li> <li>c. Continued development and delivery of Financial Management Training for Senior Executive Service, Executive Level 1/2 and ADF equivalents with an increased regional delivery focus; and</li> <li>d. Develop and pilot new courses as training needs are identified.</li> </ul>

Remediation plan	Activity	Major outcomes
<b>S1: Stores Record Accuracy</b>		
<p>Defence 'self-qualified' stock quantities relating to general stores inventory and repairable items in 2003-04, following adverse stocktake results. The ANAO Office noted material weaknesses in the internal controls over stocktaking, failure to accurately record and report physical asset quantities, and inadequate system controls to safeguard the accuracy of data. This resulted in a significant range of uncertainty around general stores inventory and repairable items balances.</p> <p>During the 2004-05 systems audit of the Standard Defence Supply System (SDSS), the ANAO have indicated that the control and compliance mechanisms were not adequate and did not provide assurance about the data in the system. Due to the limitation of scope for the opening balances for 2005-06 the qualification was not resolved this financial year.</p> <p>Full remediation of all inventory issues is forecasted for completion by 2008.</p> <p>Accountable officer: Commander Joint Logistics</p>	<p>Remediate the general stores inventory and repairable items qualification by:</p> <ol style="list-style-type: none"> <li>Implementing control and compliance mechanisms for the SDSS to provide assurance for the systems information for Joint Logistics Command warehouses;</li> <li>Correcting errors in stores record quantities in the SDSS; and</li> <li>Promulgating and ensuring compliance with stocktaking policy to improve stocktaking practices and reporting.</li> </ol>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>Defence continued to improve the processes, procedures and controls for all stock quantities, including Repairable Items;</li> <li>SDSS Information Technology controls framework implemented;</li> <li>New stocktaking practices and procedures implemented;</li> <li>Policies and procedures implemented to ensure that SDSS stock locations are verifiable;</li> <li>Performance measures developed to drive timely reconciliation of returns from Navy ships;</li> <li>The policies, procedures and practices for the movement and disposal of explosive ordnance implemented and effective;</li> <li>The instances of serial number and equipment tracking mismatch were reduced;</li> <li>The monitoring of disposed explosive ordnance discrepancies was implemented and a formal risk assessment undertaken;</li> <li>Inventory sample tool rolled out to Joint Logistic</li> <li>Command warehouses; Increased disposal volume over 2004-05 achievements; and</li> <li>\$1.036 billion Repairable Item quantities verified.</li> </ol> <p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>Complete verification of the remainder of Repairable Items;</li> <li>Segmentation of General Stores Inventory to allow analysis and verification of an aged profile;</li> <li>Second year of the recommenced two-year cyclic stocktake; and</li> <li>Prepare for the implementation of the Military Integrated Logistics Information System as the replacement for SDSS in 2008.</li> </ol>

Remediation plan	Activity	Major outcomes
<p><b>S2: General Stores Inventory Pricing and Accounting</b></p> <p>The 2003-04 Financial Statements had a limitation of scope qualification of approximately \$2,026m with regard to uncertainty around the general stores inventory balance, of which approximately \$610m relates to uncertainty around general stores inventory pricing carried over from 2002-03.</p> <p>At issue was Defence's inability to produce, in a timely manner, invoice and contract documentation to validate the prices in the SDSS. The concerns of the ANAO also included the lack of accounting policy in place to ensure the correct treatment of general stores inventory.</p> <p>Inventory pricing issues continue to be assessed in against the requirements of the AIFRS. The implementation of an even more onerous reporting requirement places greater long-term uncertainty across inventory pricing issues.</p> <p>General Stores Pricing and accounting issues are not expected to be fully resolved until 2008.</p> <p>Accountable officer: Chief Finance Officer, Defence Materiel Organisation</p>	<p>Remediate the general stores inventory pricing and accounting qualification by:</p> <ol style="list-style-type: none"> <li>a. Developing a statistical model to validate legacy (pre-1997) priced items;</li> <li>b. Implementing an exception reporting regime to provide quality assurance;</li> <li>c. Establishing policies and procedures for inventory pricing controls on the Standard Defence Supply System; and</li> <li>d. Establishing policy to ensure the correct treatment of general stores inventory.</li> </ol>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>a. The Australian Accounting Standards Board consulted in relation to inventory accounting issues;</li> <li>b. Statistical sampling of data undertaken and identified prices potentially requiring error correction where available;</li> <li>c. Quantification of excess or insurance stock</li> <li>d. calculated; Established an exception reporting regime to provide quality assurance of in-year inventory prices; and</li> <li>e. Promulgated financial accounting general stores inventory policy.</li> </ol> <p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>a. Remediation of the audit issue relating to Limitation of Scope – Inventory pricing carried forward from 1999-00 to continue with respect to potential surrogate price sources;</li> <li>b. Complete the financial requirements specification for the Materiel Logistics Financial Framework for inclusion in a replacement logistics system; and</li> <li>c. Review implementation to determine system and data retention impacts for multiple pricing records.</li> </ol>

Remediation plan	Activity	Major outcomes
<b>S3: Supply Customer Accounts</b>		
<p>A supply customer account is a location indicator within the SDSS used to track and manage assets and accountable inventory moving through the supply chain, predominantly outside a warehouse structure.</p>	<p>Remediate the supply customer account element of the repairable item quantities qualification by:</p> <ol style="list-style-type: none"> <li>Allocating an accountable owner to all supply customer accounts;</li> <li>Ensuring all supply customer account balances recorded on the SDSS are correct; and</li> <li>Improving business processes and controls for supply customer accounts.</li> </ol>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>Accountable owners identified for all supply customer accounts;</li> <li>Stocktaking completed for 89 per cent of supply customer accounts and corresponding balances corrected on SDSS;</li> <li>Defence recommenced its stocktaking program;</li> <li>Revised the repair vendor supply customer accounts arrangements to improve management and control between repair vendors and system program offices; and</li> <li>Provided enhanced reporting to assist the responsible managers to fulfil their obligations and improve the quality of supply customer account data.</li> </ol>
<p>The 2003-04 financial statements had a limitation of scope qualification of \$2,857m with regard to the uncertainty around the repairable items balance, of which supply customer accounts are a subset (\$1,000m). The ANAO concerns rested with the controls and management of supply customer accounts, including repairable items, and adherence to stocktake procedures.</p>	<p>Note: These include improvements to data creation, maintenance and reporting to ensure accurate quantity, ownership and location details are entered and maintained for all supply customer accounts on the SDSS.</p>	<p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>Complete stocktake of remaining supply customer accounts and correct balances recorded on the SDSS; and</li> <li>Continue to improve business processes regarding management and use of supply customer accounts, incorporate these processes into the Defence Supply Chain Manual and transition the new controls into standard corporate governance activities of all Groups.</li> </ol>
<p>Accountable officer: Chief Joint Logistics</p>		



Remediation plan	Activity	Major outcomes
<b>S4: Explosive Ordnance</b>		
<p>The 2003-04 financial statements had a limitation of scope qualification of \$845m relating to uncertainty around explosive ordnance pricing. At issue was Defence's inability to produce, in a timely manner, invoice and contract documentation to validate the explosive ordnance inventory prices recorded in the explosive ordnance procurement management system, Computer System Armaments.</p>	<p>Remediate the explosive ordnance inventory pricing qualification by:</p> <ol style="list-style-type: none"> <li>a. Sourcing (where possible) original ordnance inventory prices;</li> <li>b. Developing tools to substantiate explosive ordnance inventory values when appropriate supporting documentation cannot be located to support prices; and</li> <li>c. Improving and integrating explosive ordnance inventory accounting and systems management processes. These changes are designed to confirm the accuracy of asset values and enable adherence to financial documentation to substantiate explosive management standards.</li> </ol>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>a. Addressed a total of \$590m of the \$845m price qualification comprising \$346m in audit approval requests sent to the ANAO and \$244m in identified provisions and other movements relating to the explosive ordnance price qualification;</li> <li>b. Implementation commenced of a training program to better identify and mitigate UNIX risks;</li> <li>c. Formulation and implementation of a compliance framework to ensure user access is managed effectively;</li> <li>d. Periodic reviews implemented to ensure access management is effective; and</li> <li>e. Improved integration of explosive ordnance asset and accounting inventory processing and reconciliation procedures.</li> </ol> <p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>a. Continue the improvement in explosive ordnance inventory processing and reconciliation policies and procedures</li> <li>b. Implement financial reconfiguration policies to improve the pricing accuracy of complex inventory assets; and</li> <li>c. Continue the program of enhancing computer systems to automate accurate pricing of explosive ordnance assets.</li> </ol>
<p>The qualification represented approximately 38 per cent of explosive ordnance inventory and predominantly relates to direct purchase items and items acquired as part of asset under construction contracts between 1982 and 2000.</p>		
<p>Accountable Officer: Head Electronic and Weapon Systems Division, Defence Materiel Organisation</p>		

Remediation plan	Activity	Major outcomes
<b>S5: Military Leave Records</b>		
<p>The 2002-03 financial statements had a limitation of scope for military leave provisions because insufficient supporting documentation was available for leave records and, where documentation was available, unacceptable error rates existed in the recording of leave transactions. These shortcomings were mainly attributed to inadequate controls and processes within the military personnel systems and the inability to locate source documentation.</p>	<p>Remediate the military leave provisions qualification by:</p> <ol style="list-style-type: none"> <li>a. Implementing a risk stratification and sampling methodology to quantify the risk to Defence accounts;</li> <li>b. Providing an accurate representation of the military leave liability by ensuring the integrity of military leave data captured and recorded in PMKeyS; and</li> <li>c. Applying quality assurance to business processes, record keeping strategies, reporting structures, relevant policy foundations, training initiatives and a controls framework.</li> </ol>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>a. The audit qualification on Military Leave has been removed, by validation of military leave records and balances for the financial year 2005-06. This included leave record substantiation, a review of controls and analytical review of PMKeyS data;</li> <li>b. The validation tasks have confirmed the integrity of military leave data captured and recorded in PMKeyS, and have demonstrated to Management's satisfaction, that Defence's 2005-06 military leave balances are materially correct;</li> <li>c. Application of quality assurance to key business processes, including the refinement and release of instructions on leave management, and the ongoing checking of leave records, has enhanced the management of military leave; and</li> <li>d. The Leave Control Review demonstrated that a robust internal control environment in and around the military employee leave processes exists.</li> </ol>
<p>The prior year limitation had resulted in a wide-ranging military leave remediation program but Defence did not expect to resolve the problems before 2005. Defence again 'self-qualified' the military leave provision in 2003-04.</p>		
<p>Accountable officer: First Assistant Secretary Personnel Services Division, Defence Support Group.</p>		<p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>a. Continue to embed an ongoing regime for the testing of leave controls, and</li> <li>b. Continue to enhance leave management processes through ongoing refinement of management structures, operating procedures and information technology support.</li> </ol>

Remediation plan	Activity	Major outcomes
<b>S6: Civilian Leave Records</b>		
<p>In 2003-04, the ANAO noted problems with civilian leave and payroll processing. The systems issues identified in the management of military leave provisions also affect civilian leave balances.</p> <p>Accountable officer: First Assistant Secretary Personnel Services Division, Defence Support Group.</p>	<p>Remediate the civilian leave provisions qualification by:</p> <ul style="list-style-type: none"> <li>a. Implementing a risk stratification and sampling methodology to quantify the risk to Defence accounts;</li> <li>b. Providing an accurate representation of the civilian leave liability by ensuring the integrity of civilian leave data captured and recorded in PMKeyS; and</li> <li>c. Applying quality assurance to business processes, record keeping strategies, reporting structures, relevant policy foundations, training initiatives and a controls framework.</li> </ul>	<p><b>Achieved in 2005-06:</b></p> <ul style="list-style-type: none"> <li>a. The audit qualification for civilian leave was removed, by validation of civilian leave records and balances for the financial year 2005-06. This included leave record substantiation, a review of controls and analytical review of PMKeyS data;</li> <li>b. The validation tasks have confirmed the integrity of civilian leave data captured and recorded in PMKeyS, and have demonstrated, to management's satisfaction, that Defence's 2005-06 civilian leave balances are materially correct;</li> <li>c. Application of quality assurance to key business processes, including the refinement and release of instructions on leave management, and the ongoing checking of leave records, has enhanced the d. management of civilian leave; and</li> <li>d. The Leave Control Review demonstrated that a robust internal control environment in and around the civilian employee leave processes exists.</li> </ul> <p><b>Planned for 2006-07:</b></p> <ul style="list-style-type: none"> <li>a. Continue to embed an ongoing regime for the testing of leave controls; and</li> <li>b. Continue to enhance leave management processes through ongoing refinement of management structures, operating procedures and information technology support.</li> </ul>

Remediation plan	Activity	Major outcomes
<b>S7: Executive Remuneration</b>		
<p>The Executive Remuneration Note (containing information pertaining to civilian and military leave provisions) could not be reliably certified in 2004-05 because of the limitation of scope within the Australian National Audit Office 2002-03 audit report regarding military leave provisions.</p> <p>A separate limitation of scope was applied to the Executive Remuneration Note in respect of any accruals effects arising from the military leave balances. During the 2005-06 period, Defence focused on further improving the accuracy of leave records for the Senior Executive Service and military equivalents by gaining written agreement with the Auditor General on appropriate actions for remediation. These are outlined under Activities.</p> <p>Accountable officer: First Assistant Secretary Personnel Services Division, Defence Support Group.</p>	<p>Remediate the Executive Remuneration Note qualification by:</p> <ol style="list-style-type: none"> <li>a. Accepting current leave balances, after a 30 day personnel review period, with a process of appeal;</li> <li>b. Requiring leave records to be subject to a 100 per cent audit confirmation for validity of movements in the last 12 months;</li> <li>c. Requiring performance of a 100 per cent audit of leave records accepting self confirmation where there is missing documentation;</li> <li>d. Providing a signed declaration from Secretary and the Chief of the Defence Force deeming the balances to be materially correct; and</li> <li>e. Improving the standardisation of processes and controls with mandatory quality assurance checks and the development of an explanatory manual outlining Executive Remuneration Note processes and controls.</li> </ol>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>a. Self confirmation received from all Senior Executive Service and military equivalents of their current annual and long service leave balances;</li> <li>b. A 100 per cent audit completed of all Senior Executive Service and military equivalents, including validity of movements in the last 12 months;</li> <li>c. A signed declaration gained from Secretary and the Chief of the Defence Force deeming the balances to be materially correct;</li> <li>d. Mandatory quality assurance checks and the Executive Remuneration Note manual developed; and</li> <li>e. The Executive Remuneration Note being no longer qualified as a result of the achievements outlined above.</li> </ol> <p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>a. Continue to review and verify leave balances for Senior Executive Service and military equivalents.</li> </ol>

Remediation plan	Activity	Major outcomes
<b>S8: Property Valuations</b>		
<p>In 2004-05, the ANAO issued a 'limitation of scope' for land, buildings and infrastructure and other plant and equipment as significant flaws were identified in associated project management, reporting practices and management review functions. The requirements to be met by the Australian Valuation Office (AVO) were not fully and adequately documented and Defence was considered to have misinterpreted the results of revaluations and incorrectly applied depreciation. A particular consequence has been the misapplication of remaining useful life data provided by the independent valuer. This affected both the valuation adopted by Defence and the reported depreciation expense.</p> <p>Accountable officer: Deputy Secretary Corporate Services/Chief Information Officer</p>	<p>Remediate the land, buildings and infrastructure and other plant and equipment qualification by:</p> <ol style="list-style-type: none"> <li>Revising the AVO engagement letter to clarify valuation policy, procedures and outcomes;</li> <li>Contracting the AVO to revalue all land, buildings and infrastructure and other plant and equipment assets to fair value in accordance with policy guidance;</li> <li>Undertaking quality assurance on AVO site reports to ensure completeness;</li> <li>Entering revaluation data into the financial system (ROMAN) and completing revised depreciation calculations;</li> <li>Engaging a valuation contractor for the next three year cycle, i.e. 2005-06 to 2007-08; and</li> <li>Fully documenting the revaluation process in Corporate Services Asset Management and Accounting Manual.</li> </ol>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>The audit qualification on valuations was removed by completing all required valuations including Information Communication Technology equipment;</li> <li>Undertook quality assurance of valuation data and progressively load the data into the financial system (ROMAN);</li> <li>AVO contracted to conduct the next three year valuation cycle; and</li> <li>Documented the revaluation process in the Asset Management and Accounting Manual.</li> </ol> <p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>Continue the ongoing cycle of external valuations; and</li> <li>Implement a new stocktaking and reconciliation process.</li> </ol>

Remediation plan	Activity	Major outcomes
<b>S9: Preventing the Escalation of Category A and B Findings</b>		
<p>Audit findings which could not be allocated to a General or Specific Remediation Plan were grouped under Remediation Plan S9 to ensure each finding is remediated. Any audit findings that are not resolved could escalate from Categories B and C to the most serious category, Category A. Defence has recognised the clear need to improve the outcome, focus and management of the implementation of solutions to ANAO findings.</p> <p>Accountable officer: First Assistant Secretary Financial Services</p>	<p>Prevent the escalation of Category A and B findings by:</p> <ol style="list-style-type: none"> <li>Assigning responsibility across Defence for remediation of each of audit findings not already allocated to a remediation plan;</li> <li>Establishing a project-based management system for tracking and managing resolution of these ANAO audit findings;</li> <li>Undertaking progressive and final quality assurance of the remediation outcomes; and</li> <li>Reporting progress to the Financial Statements Project Board.</li> </ol>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>Audit qualification on asset thresholds was removed; and</li> <li>Asset purchase transactions were analysed and items were capitalised as appropriate.</li> </ol> <p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>Continued review of asset capitalisation policy and introduction of new threshold; and</li> <li>Commence remediation of 2005-06 findings.</li> </ol>

Remediation plan	Activity	Major outcomes
<b>S10: Stock Holding Controls</b>		
<p>Items first found are assets and inventory items that, because of threshold and deployment policies, are not or no longer registered in a corresponding Defence register or were previously considered consumed. Where a check of stock holdings shows that the Defence register record varies from the physical quantity, an investigation into the discrepancy is undertaken and the outcome may be an adjustment to the Defence Register record, and/or a corresponding financial adjustment. While it is accepted that the normal stock adjustment process will require a certain level of adjustment activity, current levels of adjustment are considered too high and indicate poor adherence to currently approved business processes.</p>	<p>Improve stock holding controls by:</p> <ol style="list-style-type: none"> <li>Preventing or reducing the instance of items</li> <li>first found and write-offs; and Accounting for and monitoring those instances first found and write-offs considered legitimate or expected.</li> </ol> <p>Note: The remediation activities focus on preventing errant transactions on the SDSS through improvements in policy, procedure and system process, and the introduction of the investigative reporting measures to ensure compliance.</p>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>All components of S10 Plan are complete. A closure package has been delivered to the ANAO for inclusion in the 2005-06 audit.</li> <li>Developed and implemented a suite of reports in the SDSS in relation to: <ul style="list-style-type: none"> <li>– repair vendors</li> <li>– tracking of repairable items</li> <li>– items in transit</li> <li>– receipting discrepancies; and</li> </ul> </li> <li>Enhanced the SDSS controls, by restricting the ability to change item classifications between inventory and asset, to improve adherence to the accounting guidelines.</li> </ol> <p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>Continue to modify the SDSS to increase the rigour applied to tracking of repairable items and receipting discrepancies to improve data accuracy;</li> <li>Revise and promulgate supply chain policy relating to lost or damaged items and item tracking; and</li> <li>Enhance compliance and audit capability, to ensure that all users are complying with the SDSS business processes.</li> </ol>
<p>Accountable officer: Chief Operating Officer, Defence Materiel Organisation</p>		

Remediation plan	Activity	Major outcomes
<p><b>S11: Standard Defence Supply System Items Not-in-Catalogue</b></p>		
<p>Defence is investigating the extent to which items may have been incorrectly accounted for in the Statement of Financial Position. This may occur when an item is purchased via the ROMAN financial system and then not recorded and managed on the SDSS. Such items are managed and tracked locally with no central visibility. This may lead to the incorrect recording and treatment of an item's value.</p>	<p>Address the potential Not-in-Catalogue issues as they may affect the financial statements by implementing measures to prevent and remediate Not-In-Catalogue items. The activities include:</p>	<p><b>Achieved in 2005-06:</b></p>
<p>Remediation of this plan is not due for commencement until all SDSS IT Controls are implemented and are operational (30 September 2006).</p>	<p>a. Clarifying and simplifying policy directives to better support effective item identification, purchasing and management process;</p>	<p>a. Baseline Count training disseminated. The schedule for Remediation and Prevention training agreed;</p> <p>b. Reviewed and revised policies relating to Item Identification (Codification), Procurement Routing Rules and ADF Logistics Managers roles and responsibilities; and</p>
<p>Accountable officer: Chief Operating Officer, Defence Materiel Organisation</p>	<p>b. Use the redrafted policies on Item Identification (Codification), ADF Logistics Managers' roles and responsibilities, and procurement routing rules to drive new processes and procedures that will prevent the future incidence of Not-In-Catalogue;</p>	<p>c. Commenced quantification of the items in Not-In-Catalogue category across Defence.</p>
	<p>c. Developing a 'self remediation' methodology for use by units across Defence to transition Not-In-Catalogue items into the SDSS and the standard financial management regime, including development of a value proposition for the management of legacy items;</p>	<p><b>Planned for 2006-07:</b></p>
	<p>d. Developing a compliance monitoring and reporting framework to assist with adherence to new policy and process;</p>	<p>a. The remediation stream of work is targeted for completion by 30 June 2007;</p>
	<p>e. Implementing an ongoing compliance monitoring and reporting regime; and</p>	<p>b. Complete baseline count activity;</p> <p>c. Commence Unit Count training;</p>
	<p>f. Establishing a change management structure to introduce the changes to processes and procedures across Defence, which includes the coordination of training, compliance monitoring and communications.</p>	<p>d. Remediation tools finalised for the reporting of progress and the transmission of Not-In-Catalogue for codification and tracking in SDSS;</p> <p>e. Prevention strategies formulated and promulgated; and</p> <p>f. Implementation of the prevention stream of work.</p>

Remediation plan	Activity	Major outcomes
<p><b>S12: Provisions for Contaminated or Potentially Contaminated Land, Buildings and Infrastructure</b></p> <p>Defence is required to include a provision for land decontamination in the financial statements. The ANAO unable to verify the adequacy of current procedures or the accuracy/valuation and completeness of the reported provisions for land decontamination.</p> <p>Accountable officer: Deputy Secretary Corporate Services</p>	<p>Remediate the provision for land decontamination qualification by:</p> <ol style="list-style-type: none"> <li>a. Ensuring accounting policies reflect current reporting requirements;</li> <li>b. Ensuring that sufficient and appropriate policies, procedures and practices are formalised and implemented for the identification of contaminated land, valuation of required decontamination and review of procedures undertaken and assessments made; and</li> <li>c. Obtaining a clear understanding from the AVO regarding matters included in valuation assessments.</li> </ol>	<p><b>Achieved in 2005-06:</b></p> <ol style="list-style-type: none"> <li>a. Successfully achieved the first milestone of the S12 plan by using a probabilistic model in identifying provisions and contingent liabilities for contaminated sites in the Australian Capital Territory/Southern New South Wales region;</li> <li>b. A review of the balance of the estate based on assessment reports and a desktop exercise was undertaken. Provision and contingencies have been identified/calculated;</li> <li>c. A set of procedures for the Contaminated Sites Register was developed; and</li> <li>d. A position paper on site restoration provision was developed and implemented.</li> </ol> <p><b>Planned for 2006-07:</b></p> <ol style="list-style-type: none"> <li>a. The S12 methodology progressed across the estate; and</li> <li>b. Continue to review estimate of provision for site restoration.</li> </ol>



Remediation plan	Activity	Major outcomes
<p><b>S13: Commitments and Accounting for Leases</b></p> <p>The ANAO were unsatisfied with the methods used by Defence to recognise and record leases and commitments.</p> <p>Accountable officer: Chief Finance Officer</p>	<p>Remediate the audit finding issued for Commitments and Accounting for Leases carried forward from 2002-03 by:</p> <ul style="list-style-type: none"> <li>a. Defining the criteria for recording commitments; and</li> <li>b. Establishing a lease register that identifies cashflows, revenues, expenses, liabilities, receivables and commitments.</li> </ul>	<p><b>Achieved in 2005-06:</b></p> <ul style="list-style-type: none"> <li>a. A quality assurance process implemented which ensures that a new lease register is established that identifies cash flows, revenues, expenses, liabilities, receivables and commitments;</li> <li>b. The Benalla Munitions facility lease has been assessed to be a finance lease. This will not have any impact on the underlying cash statement. Quality assurance process is now in place to ensure that the commitments schedule is complete and auditable;</li> <li>c. Ongoing progress made in enhancing the schedule of commitments in relation to completeness and measurement criteria; and</li> <li>d. Master Lease Register completed to support reporting of the Schedule of Commitments with all leases correctly reported and classified.</li> </ul> <p><b>Planned for 2006-07:</b></p> <ul style="list-style-type: none"> <li>a. Schedule of Commitments completed with ANAO audit concerns from prior years fully addressed; and</li> <li>b. Continued refinement of quality assurance process for the Schedule of Commitments and Master Lease Register.</li> </ul>

- 2.16 Since the publication of this information, Defence has reported progress on these plans less comprehensively in its Portfolio Budget Statements and Annual Reports. The Committee sought evidence as to the current status of these plans through both public hearings and questions on notice. This evidence is considered below.

---

## Update on remediation plans

---

### G1: Financial Reporting Framework

---

- 2.17 In June 2005, the Department of Defence launched the Financial Controls Framework Project (now referred to as the Financial Management Framework Project). The purpose of this project is to establish an internationally-recognised best practice internal control framework in Defence and the DMO.<sup>14</sup>
- 2.18 The framework, reported as being in its first year of application as at March 2007,<sup>15</sup> is described as a formal structure within which Defence can manage its financial risks, such as the risk of non-compliance with the FMA Act 1997, the risk of procurement fraud and incorrect staff salary payments.<sup>16</sup>
- 2.19 Through the Financial Controls Framework, Defence is able, in its words, to effectively manage its financial risks by:
- documenting the key financial management processes in Defence;
  - documenting the key financial management risks;
  - identifying, documenting and categorising controls to manage the risks;
  - assigning traceable accountabilities for the controls;
  - implementing a comprehensive training regime to support financial management; and
  - establishing a single system of monitoring and maintenance to ensure that the controls framework retains its relevance and integrity.<sup>17</sup>

---

14 Department of Defence, sub 4, p 13.

15 Mr Phillip Prior, transcript, 29 March 2007, p 7.

16 Department of Defence, sub 4, p 13.

17 Department of Defence, *Annual Report 2005-2006*, p 64.

- 2.20 The core of the framework is based on the identification of 'controls'<sup>18</sup> to manage compliance risks associated with both internal (e.g., Chief Executive Instructions) and external (e.g., legislation) financial management obligations.<sup>19</sup>
- 2.21 To identify the risks, financial management obligations are subdivided along functional lines such as employee provisions, inventory, land and buildings and so on. Each risk is then assigned one or more controls to either prevent the risk from occurring or to indicate when an undesirable event has occurred.<sup>20</sup>
- 2.22 In its primary submission to the inquiry, Defence anticipates that the financial controls framework, benchmarked against similar private sector organisations, would contain up to 5,000 internal controls of which 1,000 would be considered to be key.<sup>21</sup>
- 2.23 In a supplementary submission to the inquiry, the Committee was informed that as at May 2007, 1,169 key controls had been identified to manage the financial risks to the Defence Balance Sheet with some of these controls used in multiple locations. In total there are 38,417 instances of these controls in use across the country.<sup>22</sup>
- 2.24 Defence also acknowledged in a submission to the inquiry that a controls framework will be insufficient to achieve best practice financial management. Defence advised that regimes to monitor both the level of conformance with the framework and the financial management performance of Defence were being developed.<sup>23</sup>
- 2.25 According to the Chief Finance Officer of Defence, this framework is now embedded in the organisation:

We monitor our controls, we have identified our key financial risks and we report on those monthly. I review and monitor those as they are done by people in my organisation. The internal audit group then come in behind us and do their audit spot checks and so on to ensure that those control assessments that we make are

---

18 Department of Defence, sub 4, p 13, defines controls as: "...specific actions or activities that are implemented to mitigate the likelihood of these occurring and can be either automated within financial management systems or manually applied."

19 Department of Defence, sub 4, p 13.

20 Department of Defence, sub 4, pp 13-14.

21 Department of Defence, sub 4, p 14.

22 Department of Defence, sub 4.3, Attachment A.

23 Department of Defence, sub 4, p 14.

valid. From my point of view, I think that that control framework is now in place and working.<sup>24</sup>

- 2.26 In its interim phase of the audit of financial statements for the year ending 30 June 2008, the ANAO reported the following:

The 2006-07 financial year was the first year that independent testing and control-self assessment over the majority of identified controls was completed. Over 750 control tests were performed with 89 per cent identified as being fully effective across significant balance sheet accounts. Subsequently a control effectiveness statement was issued to assist the Secretary and the CFO of Defence in their signing of Defence's 2006-07 financial statements.<sup>25</sup>

#### Committee comment

- 2.27 The Committee is satisfied from the evidence obtained that this framework is now well established and the monitoring process is ongoing. However, the Committee notes and echoes the following comments of the ANAO:

Defence's commitment to implementing the Financial Management Framework and a continued focus on developing its internal control environment, has resulted in a gradual improvement to the level of outstanding audit findings. Critical to the ongoing success of these activities is the need to maintain an enterprise-level focus on remediation activities and the implementation and maintenance of control activities.<sup>26</sup>

---

## G2: Managing the ANAO Annual Audit Process

---

- 2.28 As outlined in the remediation plans above, this plan recognises the importance of having clear agreement between the ANAO and Defence on issues related to the finalisation of the annual financial statements.

---

24 Mr Phillip Prior, transcript, 29 March 2007, p 15.

25 ANAO Audit Report No. 44 2007-08 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2008*, p 111.

26 ANAO Audit Report No. 44 2007-08 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2008*, p 120.

2.29 Understandably, the degree to which parties are able reach agreement will be largely determined by the nature of the relationship between them. The Committee heard from a number of witnesses that the relationship between Defence and the financial audit staff at the ANAO was a healthy and collaborative one. Mr Phillip Prior, the current Chief Finance Officer (CFO), Department of Defence stated:

I think that we have a very healthy relationship with the ANAO, a strong professional relationship. We submit our financial statement plan for the year to the auditors early in the financial year, and we discuss it and work through it together. We have a very mature process of sharing information at the highest strategic level for our financial statements.<sup>27</sup>

2.30 Dr Stephen Gumley, Chief Executive Officer (CEO), DMO, reaffirmed this view:

The relationship with the Audit Office on the financial audits, I think, is excellent at the moment. I am delighted with the co-operation on financial audits. They audit our processes and they do a bit of green-pen ticking of individual transactions to check that the processes are working. There is an open dialogue on financial audits. It is going well. We make some mistakes and they find them, and that is fine. We correct our mistakes and so on.<sup>28</sup>

2.31 From an ANAO perspective, Mr Michael White indicated that having specific officers within Defence who facilitate the audit process had:

...worked quite well in terms of making sure the communication flows smoothly through the audit process.<sup>29</sup>

2.32 And, the Auditor-General stated:

...on the financial statement work...for the past two years there has not been disagreement at the end of the day about what the issues are, what the judgements are on those major issues, and where progress needs to be made. We have provided comments to Defence on its remediation programs. I and my senior staff talk at Defence management programs. So, overall, we do have some relationship issues from time to time, but they are not significant enough to get in the way of matters.<sup>30</sup>

---

27 Mr Phillip Prior, transcript, 29 March 2007, pp 17.

28 Dr Stephen Gumley, transcript, 9 May 2007, p 22.

29 Mr Michael White, transcript, 13 June 2007, p 3.

30 Mr Ian McPhee, transcript, 17 August 2006, p 6.

---

**Committee comment**

- 2.33 On balance, the Committee was in agreement with Mr Prior's assessment that this plan was past remediation and was now embedded.<sup>31</sup> The Committee is gratified that the relationship between Defence and the ANAO in relation to financial matters has been described in positive terms. The Committee hopes this cooperation between the ANAO and Defence will continue to develop over time.
- 2.34 However, the Committee notes that the relationship with the Audit Office in terms of performance audits (i.e., audits which can review or examine any aspect of the operations of the person or body<sup>32</sup>) was not described by Defence in the same positive terms. This issue is raised further in Chapter 5.
- 

**G3: Financial Management and Systems Training – Financial and Business Management**

---

- 2.35 This plan was developed in recognition of the need for Defence to enhance the skills of staff in the execution of financial management and adhere to approved procedures in the use of corporate information technology systems.<sup>33</sup>
- 2.36 The Committee notes and is in agreement with Defence's view on the need for financial skilling right across the Department:
- In some way every member has the potential to impact on Defence's financial statements, for example, through the management of leave balances, the acquittal of business travel or the efficient and effective use of the Defence suppliers' budget. It can therefore be said that all Defence staff undertake financial activities. While some will clearly identify themselves as having a financial management function, others currently do not recognise themselves as having a financial role or responsibility.<sup>34</sup>
- 

31 Mr Phillip Prior, transcript, 29 March 2007, p 17.

32 Australian National Audit Office, *Planned Audit Work Programme 2007-08*, p 10.

33 Department of Defence, sub 4, p 32.

34 Department of Defence, sub 4, p 17.

2.37 The Committee also notes that Defence has invested considerable funds and effort into its financial skills training program. For example:

A dedicated Financial Training Branch has been established under the Defence Chief Finance Officer to identify and develop training for, the learning outcomes that are emerging from all of our initiatives, reforms and in the financial management environment.

An amount of \$35m has been allocated over ten years (to 2015-16) to deliver an effective financial management skilling system that meets the needs of Defence and its people working in the finance domain.<sup>35</sup>

2.38 At the inquiry's first hearing on 11 May 2006, the former Secretary of Defence, Mr Ric Smith indicated that training in financial management and IT systems had been provided to approximately 7,300 staff in 2004-05 and 9,400 to March 2006.<sup>36</sup>

2.39 This training falls into the following categories: *financial management training* (training support provided to the Senior Leadership Group and senior officers); *financial information systems training* (training in corporate financial management systems such as ROMAN and BORIS); *finance and business training* (such as accrual accounting and finance induction); *tertiary financial training* (including 2 tertiary training courses); and *e-learning*.<sup>37</sup>

2.40 Since 2004-05, training expenses have increased from an actual \$2.267 million in 2004-05 to an estimated \$3.786 million in 2006-07.<sup>38</sup> Similarly, the number of people who have undergone financial training has also increased:

I think we have trained something like 10,000 people in financial management in this current year – the year to date. Last year, 2005-06, 14,610 people were put through financial management training programs. This year from February to date there have been 10,331 people.<sup>39</sup>

---

35 Department of Defence, sub 4, p 21.

36 Mr Ric Smith, transcript, 11 May 2006, p 4.

37 Department of Defence, sub 4, p 16.

38 Department of Defence, sub 4.3.

39 Mr Phillip Prior, transcript, 29 March 2007, p 16.

- 2.41 In its Annual Report for the year 2006-07, Defence further reports:
- During the year 18,916 people were provided with finance-related training.<sup>40</sup>
- 2.42 The Committee notes that Defence, like other public sector organisations, continues to face a number of challenges as a result of the current skills shortage and the consequent competition amongst agencies for staff with the appropriate level of expertise. This issue is also addressed in Chapter 4.

#### Committee comment

- 2.43 The Committee welcomed comments from the CFO of Defence, that while he no longer saw training as a remediation activity, he did not assume that Defence's investment in training would taper off. For example, as new reporting requirements emerged there would be a corresponding requirement for training:
- We do not rest on our laurels...We try to look ahead and plan the future needs of our people across the organisation. When some of the base training starts to embed and become absorbed, we then try to develop more plans that take us to a further level.<sup>41</sup>
- 2.44 However, the Committee is concerned about the extent to which this significant investment in financial skills training will impact on Defence's culture around financial management over the longer term. For example, while an increasing number of staff may be equipped with financial skills, to what extent do they believe they play a role in the financial management of the Department? The Committee's concern with the culture underlying the problems with Defence's financial management is echoed in the following comments made by the current Secretary of the Department, Mr Nick Warner to the Lowy Institute in June this year:
- Financial management encompasses a lot more than our financial statements...[a]nd the real problem is not actually the numbers themselves – it's the flawed behaviour, systems and processes that produce the wrong numbers.<sup>42</sup>

---

40 Department of Defence, *Annual Report 2006-07*, p 32.

41 Mr Phillip Prior, transcript, 29 March 2007, p 18.

42 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008, p 5.



- 2.45 The Committee considers that such a large investment in financial training should be accompanied by an appropriate evaluation strategy to ensure a commensurate return on the investment.
- 

## S1: Stores Record Accuracy

---

- 2.46 The purpose of this plan is to remediate the significant range of uncertainty that existed around Defence's 'self-qualified' stock quantities related to general stores inventory and repairable items.<sup>43</sup>

- 2.47 Mr Prior provided an update on this remediation plan on 29 March 2007, as follows:

We have a two-year rolling stocktaking process in place and it has been in place for some years. It is now at a mature state. I see regular reports now about our stocktaking effort...I see what I expect to see – that is, information flowing about the results of stocktakes, which are done on a regular basis. So information is flowing through. We are getting closer and closer to the point where we think we have a stocktaking process which is now business as usual. Does that stocktaking process identify stock movements and adjustments? Yes, it does, as it should do. We have a stocktaking process which, as I understand it...is down at the bin level. It is down at a very low level. We have well in excess of 150 million individual items and we are counting down at the bin level across 1,100-odd warehouses.<sup>44</sup>

- 2.48 At that hearing, Mr Prior was unable to provide the Committee with a current estimate of the extent of material deficiencies in stores inventories across Defence. Since that time, however, the Committee has received a further submission from the Department of Defence which reports progress on stores accuracy for the 2006-07 financial year as follows:

In general terms, progress has been good. Management is now able to assert reliance on controls, that the location of [General Stores Inventory] and [Repairable Items] quantities is known and

---

43 Department of Defence, sub 4, p 33.

44 Mr Phillip Prior, transcript, 29 March 2007, p 19.

managed and that the not-in-catalogue uncertainty has been remediated.<sup>45</sup>

- 2.49 However, consistent with the ANAO's audit findings for the period ended 30 June 2007<sup>46</sup>, Defence's submission 4.5 sets out that some uncertainty surrounding General Stores Inventory remains:

During the 2006-07 financial year, a number of activities were undertaken to assist management to form a view as to the status of GSI quantities.

The results of these measures are positive and have given management increased confidence that Defence knows where its inventory is located and how it is being managed.

However, noting that there remain outstanding issues surrounding GSI prices, at this stage management is still faced with uncertainty regarding some legacy pricing and will therefore not be in a position to form an opinion about the entire GSI balance for 2006-07.<sup>47</sup>

- 2.50 The Committee notes that future issues related to General Stores Inventory will be dealt with by an *Inventory Tiger Team*. Defence's *Portfolio Budget Statements 2007-08* sets out the work of the team as follows:

...this team was established to assist in the removal of uncertainty around General Stores Inventory and Repairable Items. The approach is focused on establishing controls reliance and substantiating quantities and prices.<sup>48</sup>

- 2.51 The Committee also welcomes the comments of Mr Nick Warner, the current Secretary of Defence in reassessing the approach to ordering and maintaining stock levels and his desire to modernise the warehouse management system.<sup>49</sup>

---

45 Department of Defence, sub 4.5, p 1.

46 For further detail see, Australian National Audit Office, Audit Report No. 18 2007-08, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2007*, pp 94-95.

47 Department of Defence, sub 4.5, p 2.

48 Department of Defence, *Portfolio Budget Statements 2007-08*, p 204.

49 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008.

## S2: General Stores Inventory Pricing and Accounting

---

- 2.52 As outlined in the remediation plan tables above, this remediation plan arose as a result of Defence's inability to produce, in a timely fashion, documentation to validate the prices of general stores inventory recorded in SDSS which lead to qualifications in the 2003-04 and 2004-05 Financial Statements.<sup>50</sup>
- 2.53 At the hearing on 29 March 2007, the Committee was advised that Defence was still working through three significant components to S2. These included: inventory pricing in light of the Australian Equivalents to International Financial Reporting Standards (AEIFRS); legacy invoices; and 'the one dollar problem'.
- 2.54 With regard to inventory pricing in light of the AEIFRS, one of the difficulties associated with this remediation plan has been that inventory pricing issues are assessed against the requirements of the AEIFRS. That is, under the AEIFRS (i.e., AASB 102 *Inventories*), Defence is required to record inventory at the lower of cost or current replacement, and, because Defence holds a large amount of inventory that has been held for many years, it is difficult to determine its replacement cost.
- 2.55 On the basis of concerns raised about the application of AASB 102 *Inventories*, in March 2007 the Australian Accounting Standards Board (AASB) released an exposure draft entitled *Proposed Amendments to AASB 102 - Inventories Held for Distribution by Not-for-Profit Entities* (Exhibit 3). Defence indicated at the hearing on 29 March 2007 that if approved by the AASB, this amendment would mean Defence could revert to recording inventory at cost.
- ...given that [approval] all happens, that problem we had with pricing will go away, and we can revert to recording our inventory just at cost. Moving forward, that means that that is now something that we can get on and do.<sup>51</sup>
- 2.56 The Committee received an update on 4 June 2008 as follows:
- AASB 2007-5 Amendments to Australian Accounting Standard - Inventories Held for Distribution by Not-for-Profit Entities [AASB
- 

50 Department of Defence, sub 4.5, p 34.

51 Mr Phillip Prior, transcript, 29 March 2007, p 25.

102] was released by the Australian Accounting Standards Board (AASB) in May 2007 with an application date for reporting periods beginning on or after 1 July 2007. The amendment required not-for-profit entities to measure inventories held for distribution at cost, adjusted where applicable for any loss of service potential.

Defence adopted this amendment early from 1 July 2006 as permitted by the then Department of Finance and Administration...<sup>52</sup>

- 2.57 With regard to legacy invoices, records associated with some inventory held in Defence go back many years and in many cases are not readily available. For example, as at March 2007, in the Standard Defence Supply System (SDSS), there were close to \$100 million in general stores that have had neither receipts nor issues against them since 1993<sup>53</sup> calling into question the current value of those items.
- 2.58 Additionally, the 'one dollar problem' has arisen because SDSS was originally set up as a logistics management system. This meant the focus was on the quantity rather than the price of inventory and staff were instructed to enter either "zero or one as the value"<sup>54</sup> of each item.
- 2.59 Defence is working with the AASB and the ANAO to develop a method of determining legacy priced items. In a submission to the inquiry, Defence outlines its approach to addressing GSI pricing uncertainty as follows:

Defence has developed a comprehensive plan to substantiate and, where necessary, remediate pricing where historical prices are unable to be verified. The execution of this plan will require extensive internal and external resources. Concurrently, Defence is working with the AASB to obtain relief from the requirement to demonstrate verifiable prices for legacy GSI. In the meantime Defence has commenced work, in consultation with the ANAO, to execute the GSI legacy pricing plan outlined below.

At the top level, Defence has segmented GSI based on the likelihood that documentation exists to support the GSI price records in the Defence logistics system. This has resulted in pre-2000 and post-2000 segments.

The pre-2000 segment has been further divided into:

---

52 Department of Defence, sub 4.7.

53 Mr Mark Jenkin, transcript, 29 March 2007, p 26.

54 Mr Mark Jenkin, transcript, 29 March 2007, p 28.

- Items that are Potentially Surplus or Obsolete. These items have had no issues since 2000 (116,000 stockcodes valued at \$178 million) and are being reviewed. It is anticipated the majority of these items will be fully adjusted for the loss in service potential and subject to disposal action. These items will not require any pricing substantiation.
- Items which were last received pre-2000 but have had issues post-2000 (194,000 stockcodes valued at \$562 million). Defence has engaged the Australian Valuation Office (AVO) to substantiate the prices on the Defence logistics system. Where the AVO is unable to substantiate the price, it will provide an estimate of the current replacement costs of the stock item. Defence will then consider the need to index to the date of purchase using the relevant Australian Bureau of Statistics index to obtain an appropriate surrogate purchase price. The current replacement cost is considered to be the most appropriate and reliable estimate of cost for GSI that cannot be substantiated with existing documentation.

For the post-2000 segment (166,000 stock codes valued at \$1.5 billion), Defence has adopted an Acceptance Testing approach based on advice from expert statisticians. A sample of purchase records has been selected from materiel procurement sites across Defence. Purchasing documentation is to be collected for each record and compared with the electronic record on the Defence logistics system. This process will identify those areas where procurement practices are sound and any areas that require remediation. Appropriate adjustments can then be made to the financial record.

The overall outcome of this work is expected to provide Defence management with sufficient assurance that the GSI balance is not materially misstated.<sup>55</sup>

- 2.60 The Committee notes, and is supportive of, discussions that are still taking place between the AASB, the Auditor-General and Defence regarding the resolution of these issues. The Committee also notes the ANAO's report on the status of this work as follows:

Defence has recently commenced comprehensive programs to assess GSI quantities and legacy pricing issues that contributed to the qualification of the 2006-07 financial statements. Key activities involved in the program include a third party assurance process over GSI quantities and a statistical sampling program over GSI

---

55 Department of Defence, sub 4.7.

pricing. These strategies and the results stemming from them are under review by the ANAO.<sup>56</sup>

- 2.61 The Committee will monitor progress on this remediation plan.
- 

### S3: Supply Customer Accounts (SCAs)

---

- 2.62 Supply customer accounts are used to track and manage assets and accountable inventory through the supply chain.<sup>57</sup> The aim of this plan was to improve management of these assets.

- 2.63 The Department of Defence *Annual Report 2005-2006* reports:

All remediation actions in relation to this plan have been completed. All SCAs now have a responsible officer and improved management processes are in place.<sup>58</sup>

- 2.64 The Committee is satisfied on the basis of that report, that this remediation plan is closed.
- 

### S4: Explosive Ordnance

---

- 2.65 The purpose of this plan is to ensure appropriate substantiation of explosive ordnance (EO) pricing and establish and implement policies for the correct recording of EO.

- 2.66 The removal of the explosive ordnance qualification was reported to the Committee by Defence on 29 March 2007.<sup>59</sup>

- 2.67 The ANAO describe the activities leading to the lifting of this qualification as follows:

In 2004-05, there was uncertainty surrounding the pricing of a portion of the EO balance, as Defence was unable to provide sufficient supporting documentation to support the recorded

---

56 ANAO Audit Report No. 44 2007-08 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2008*, p 116.

57 Department of Defence, sub 4, p 36.

58 Department of Defence, *Annual Report 2005-2006*, p 66.

59 Mr Phillip Prior, transcript, 29 March 2007, p 29.

value...In 2005-06, Defence remediated this balance and reduced the uncertainty due to several actions, firstly, by writing down the value of inventory to the lower of cost and current replacement cost in accordance with AASB 102 *Inventories*, and secondly, use of 'best estimate' values where primary documentation was not available. These actions, together with the corrections of prior year errors under AEIFRS, resulted in the uncertainty in relation to the balance being mitigated for 2005-06 and the comparative year.<sup>60</sup>

- 2.68 While the Committee welcomes the closing of this remediation plan, it is keenly aware that issues relating to EO are of great consequence to the Government, Defence and the Australian public. Matters relating to the theft of M72 rocket launchers featured at different points during the inquiry. The Committee therefore makes note of and welcomes the comments of Mr Warner that accountability for the complete oversight of EO management has been given to the Vice Chief of the Defence Force. The Committee also notes that the following activities are high on Defence's agenda in light of its recent audit of security policy and practices applying to weapons, munitions and explosives:<sup>61</sup>

...revising EO accounting procedures, improving physical security at weapons and EO storage facilities, and consolidating the myriad of publications in this area into a single, easily understood and accessed reference point.<sup>62</sup>

---

## S5: Military Leave Records and S6: Civilian Leave Records

---

- 2.69 As a result of insufficient documentation and unacceptable error rates in processing military and civilian leave, the aim of these plans is to ensure the integrity of leave data recorded in PMKeyS (i.e., Defence's primary information management system supporting personnel management).
- 2.70 The ANAO reports that Defence has now successfully remediated issues concerning the accuracy of civilian and military annual leave balances
- 

60 Australian National Audit Office, Audit Report No. 15 2006-07, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 105.

61 The Hon Dr Brendan Nelson MP, *Further strengthening of security for weapons, munitions and explosives*, media release, 25 September 2007.

62 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008, p 8.

and civilian long service leave<sup>63</sup> and that any future issues related to this remediation plan will be managed through the Leave Tiger Team (see section 2.92).

---

## S7: Executive Remuneration

---

- 2.71 Concerns over military and civilian leave meant that the Executive Remuneration Note, which is included in Defence's financial statements, could not be reliably certified.<sup>64</sup>
- 2.72 The ANAO concluded on the basis of a review conducted in 2005-06 that the uncertainty reported in 2004-05 with regard to leave provisions, the associated impact on leave expenses and the Executive Remuneration Note was mitigated.<sup>65</sup> This remediation plan is therefore complete.
- 

## S8: Property Valuation

---

- 2.73 The purpose of this plan is to address the flaws identified by the ANAO in project management, reporting practices and review functions around Defence's land, buildings and infrastructure assets.
- 2.74 In its *Annual Report 2005-2006*, Defence reported that all land, building and infrastructure findings were completed by 30 June 2006 and have been quality assured.<sup>66</sup> As a result, the qualifications relating to land and buildings, and infrastructure have been removed.<sup>67</sup> This remediation plan is therefore complete.
- 

63 Australian National Audit Office, Audit Report No. 15 2005-06, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 102.

64 Department of Defence, sub 4, p 39.

65 Australian National Audit Office, Audit Report No. 15 2005-06, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 106.

66 Department of Defence, *Annual Report 2005-2006*, p 67.

67 Department of Defence, sub 4.7.



## S9: Preventing the Escalation of Category A and B Findings

---

- 2.75 This plan contains audit findings that had not been allocated to a General or Specific remediation plan to ensure remediation of all audit findings. Defence recognises that any audit findings not resolved could escalate from Categories B and C to Category A (the most serious) and it acknowledges the need to improve the “outcome, focus and management of the implementation of solutions to ANAO findings”.<sup>68</sup>
- 2.76 The most recent publicly available update from Defence specifically in relation to this plan is contained in the *Department of Defence Annual Report 2005-06* is as follows:
- Remediation action has been completed for over 90 per cent of the findings allocated to this plan in 2004-05.<sup>69</sup>
- 2.77 Additionally, the Committee notes ANAO reports that Defence have made progress in reducing its high risk audit findings. For example, category ‘A’ findings decreased from 16 (at the end of the 2007 interim audit) to 9 (at the conclusion of the 2007 final audit).<sup>70</sup>
- 2.78 The ANAO make the following comment:
- When the 2006-07 result is compared with comparative reporting periods, it is evident that Defence’s focus on financial remediation has had a positive impact on the department’s internal control environment and quality of financial reporting.<sup>71</sup>
- 2.79 However, the Committee also notes ANAO advice that:
- A continued focus is required on the remediation of the moderate and lower risk issues which, in aggregate, have trended upwards over the past couple of reporting periods.<sup>72</sup>

---

68 Department of Defence, sub 4, p 40.

69 Department of Defence, *Annual Report 2005-06*, p 67.

70 Australian National Audit Office, Audit Report No. 44 2007-08, *Interim Phase of Audit of Financial Statements of General Government Agencies for the Period Ended 30 June 2008*, p 114.

71 Australian National Audit Office, Audit Report No. 44 2007-08, *Interim Phase of Audit of Financial Statements of General Government Agencies for the Period Ended 30 June 2008*, p 114.

72 Australian National Audit Office, Audit Report No. 44 2007-08, *Interim Phase of Audit of Financial Statements of General Government Agencies for the Period Ended 30 June 2008*, p 115.

---

## S10: Stock Holding Controls

---

- 2.80 The purpose of this plan is to improve stock holding controls of 'first found' (i.e., items of asset or inventory that do not have a corresponding record on an authorised Defence register) and write off items and the monitoring of legitimate occurrences.<sup>73</sup>
- 2.81 The Committee is in receipt of no information that states explicitly that this individual remediation plan is complete, however, the Committee infers from the objective of the plan and the update provided in the Department's *Annual Report 2005-06* that the remediation plan is in fact finalised:
- New policies and processes have been implemented and the monitoring of First Found and Write Off items has been improved.<sup>74</sup>
- 

## S11: Standard Defence Supply System Items Not-in-Catalogue

---

- 2.82 The objective of this remediation plan is to reduce the number of not-in-catalogue items held by Defence. To that end Defence has implemented procurement policies, processes and procedures to ensure that items being purchased are codified and loaded onto SDSS.<sup>75</sup> Defence report that during 2006-07:
- ...uncertainty around...not-in-catalogue issues was removed.<sup>76</sup>
- 2.83 The Committee is therefore satisfied that this remediation plan is complete.
- 

73 Department of Defence, sub 4, p 41.

74 Department of Defence, *Annual Report 2005-2006*, p 67.

75 Department of Defence, *Annual Report 2005-2006*, p 67.

76 Department of Defence, *Annual Report 2006-2007*, p 32.

---

## S12: Provisions for Contaminated or Potentially Contaminated Land, Buildings and Infrastructure

---

- 2.84 The objective of this remediation plan is to ensure an appropriate provision for the remediation of contaminated sites.<sup>77</sup>
- 2.85 The last publicly-available comprehensive report on this plan indicates that:
- A position paper on this issue has been developed which has enabled the determination of a provision for the 2005-06 financial statements. All extant policies have been reviewed to ensure current reporting requirements are being met. New processes in relation to updating of the contaminated sites register are being developed.<sup>78</sup>
- 2.86 The Committee assumes that on-going work relating to this plan will be undertaken by the Site Restoration Provision Project (see section 2.92 below).
- 

## S13: Commitments and Accounting for Leases

---

- 2.87 This remediation plan addresses a range of audit findings including issues related to a proposed finance lease on a munitions facility and the master lease register.<sup>79</sup>
- 2.88 The purpose of this plan was to ensure that the Schedule of Commitments and the accounting for leases are completed in accordance with relevant Defence policy and meet the accounting standard.<sup>80</sup>
- 2.89 In its 2005-2006 Annual Report, Defence reports the following:
- In accordance with the remediation plan, a new quality assurance process has been introduced that has substantially improved the completeness, accuracy and auditability of the schedule. The
- 

77 Department of Defence, *Annual Report 2005-2006*, p 67.

78 Department of Defence, *Annual Report 2005-2006*, p 67.

79 Department of Defence, sub 4, p 41.

80 Department of Defence, *Annual Report 2005-2006*, p 67.

master lease register has been significantly modified to capture more detailed information relating to cash flows, revenues, expenses, liability, receivables and commitments.<sup>81</sup>

#### Committee comment

2.90 The Committee is aware that a significant period of time has elapsed since the commencement of the inquiry and as such it expects that the remediation plans would now be nearing completion. Indeed, the Committee heard evidence on 29 March 2007 from Mr Prior that Defence will no longer be reporting on many of the 16 remediation plans:

...going forward we will not report on many of these remediation plans. My intention is to fold these activities now into the ordinary course of business, so, to the extent that leave has now been settled with the auditors, there is not much point in continually reporting it – it is done.<sup>82</sup>

2.91 Additionally, in a submission dated 5 June 2008 the Committee was advised that the last remaining area of qualification is pricing and system issues relating to General Stores Inventory.<sup>83</sup>

2.92 That Defence sees the remediation program as being in its final stages is further reaffirmed by the dedication of only one page to *Financial Reform* in the *Portfolio Budget Statements 2007-08*. The focus of future financial statements remediation outlined in this document is as follows:

- Financial Controls Framework Project – this project draws together, in a structured and integrated fashion, all of the components needed to build a best practice financial management environment for Defence. The framework provides all staff with a common understanding of the what, why, when and how of financial management in Defence.
- Inventory Tiger Team – this team was established to assist in the removal of uncertainty around General Stores Inventory and Repairable Items. The approach is focused on establishing controls reliance and substantiating quantities and prices.
- Leave Tiger Team – in 2005-06, this team was able to confirm civilian and military annual and long service leave entitlements were materially correct, resulting in removal of the previous audit qualification. The task for the team in 2006-07 and beyond is to continue improving business processes and

---

81 Department of Defence, *Annual Report 2005-2006*, p 67.

82 Mr Phillip Prior, transcript, 29 March 2007, p 41.

83 Department of Defence, sub 4.7.

controls around leave entitlements to avoid future qualifications.

- Site Restoration Provision Project – considerable work has been done to identify and record an appropriate provision for the restoration of contaminated Defence sites. While present obligations can be identified and reported appropriately, full technical assessment of all sites is an ongoing task.<sup>84</sup>

- 2.93 Similarly, Defence's *Portfolio Additional Estimates Statements 2007-08*, the *Annual Report 2006-07* and the *Portfolio Budget Statements 2008-09* dedicate very little space to the status of the remediation program or financial reform.
- 2.94 The Committee welcomes the extensive work that has been undertaken on the remediation plans, largely under the direction of Mr Phillip Prior, the Chief Finance Officer, and appreciates that Defence is keen to incorporate the outcomes of its remediation activities into its usual business practice. However, the Committee makes note that determining the status of the individual remediation plans over the course of the inquiry was not as straightforward as it would have hoped. There still being no one document that provides a definitive statement on the status of each plan.

## Position papers and adoption of the AEIFRS

- 2.95 From 1 January 2005, all reporting entities in Australia were required to adhere to new international accounting standards, the AEIFRS.
- 2.96 Where previously, financial reporting was subject to Australian Generally Accepted Accounting Principles (AGAAP), the purpose of the AEIFRS is to:
- ...increase the transparency and comparability of financial statements on a global basis through the full adoption of the International Financial Reporting Standards (IFRS).<sup>85</sup>
- 2.97 The Australian Accounting Standards Board (AASB), the Commonwealth agency responsible for developing and issuing accounting standards in Australia, issued the first standard, AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*, to facilitate compliance with the standards and

---

84 Department of Defence, *Portfolio Budget Statements 2007-08*, p 204.

85 ANAO Audit Report 21 2005-06, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2005*, p 22.

provide relief to first time adopters of the standards (e.g., exemptions to full retrospectivity in the application of new accounting policies).<sup>86</sup>

2.98 The Committee was informed by Defence that reporting 2005-06 financial information in accordance with the AEIFRS held particular challenges for Defence given its size and nature. For that reason, Defence wrote to the AASB in late 2005 seeking transitional relief and in March 2006, the AASB amended AASB 1 as follows:

Aus3.2 In rare circumstances, a not-for-profit public sector entity may experience extreme difficulties in complying with the requirements of certain Australian equivalents to IFRSs due to information deficiencies that have caused the entity to state non-compliance with previous GAAP. In these cases, the conditions specified in paragraph 3 for the application of this Standard are taken to be satisfied provided the entity:

- (a) discloses in its first Australian-equivalents-to-IFRSs financial report:
  - (i) an explanation of information deficiencies and its strategy for rectifying those deficiencies; and
  - (ii) the Australian equivalents to IFRSs that have not been complied with; and
- (b) makes an explicit and unreserved statement of compliance with other Australian equivalents to IFRSs for which there are no information deficiencies.<sup>87</sup>

2.99 As a result of this amendment, Defence was able to avail itself of relief in relation to:

- The ability to use the AGAAP carrying amounts of property, plant and equipment at 1 July 2004 as deemed cost on transition to AIFRS.
- Simplified transitional arrangements for decommissioning, restoration or similar liabilities.
- Simplified transitional arrangements for leases embedded in arrangements/contracts existing at 1 July 2004.<sup>88</sup>

---

86 ANAO Audit Report No. 48 2005-2006 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2006*, p 28.

87 Australian National Audit Office, Audit Report No. 48 2005-2006 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2006*, p 28.

88 Department of Defence, sub 4, p 49.

2.100 However, in its primary submission to the inquiry, Defence outlined a number of key challenges that remained. These are summarised as follows:

- *Embedded derivatives*: Defence will be required to identify, value and recognise embedded derivatives where such derivatives exist in existing contractual arrangements;
- *Restoration provision*: Defence will be required to provide for restoration and decontamination in relation to contaminated sites;
- *Decommissioning*: Defence will be required to provide for the decommissioning costs expected to be incurred at the end of life of items such as specialist military equipment. Provisions will be required to be booked on acquisition of those items;
- *Heritage and Cultural Assets*: Defence will be required to value and recognise heritage and cultural assets; and
- *Inventory*: Defence will be required to record inventory at the lower of cost and replacement cost requiring maintenance of two records of value for inventory items.<sup>89</sup>

2.101 Defence developed a series of 'position papers' to clarify key accounting issues related to these and other matters. In addition to seeking agreement on the application of the AEIFRS, the purpose of these conceptual papers was to maximise the likelihood that the ANAO would be in a position to form an opinion on the 2005-06 financial statements. The former Secretary of Defence, Mr Ric Smith, succinctly described the purpose of developing the position papers as follows:

What we have sought to do is to use the papers to reach agreement with ANAO about exactly what the problem is and which of the alternative approaches we will take to trying to achieve resolution.<sup>90</sup>

2.102 The proactive nature of these position papers also aligns with the views expressed in BAE Systems Australia Limited's submission:-

Given the recent history of qualified audit opinions/no opinions being expressed by ANAO it would be sensible for Defence to agree with ANAO upfront what the goals, priorities and expected outcomes of the Financial Remediation Project (FRP) should be and the interim milestones for achievement.<sup>91</sup>

---

89 Department of Defence, sub 4, p 49-51.

90 Mr Ric Smith, transcript, 11 May 2006, p 9.

91 BAE Systems Australia Limited, sub 2, p 8.

2.103 At the time of its submission, Defence had prepared 21 position papers to assist with the 2005-06 financial statements. The topics on which papers had been prepared by the Department were listed in Submission No 4 as follows:

- AASB 1 and Transition to AIFRS;
- Assertion Validation Framework and Substantiation Methodologies;
- Materiality Framework;
- Assets Under Construction;
- General Stores Inventory (Accounting Policy);
- General Stores Inventory (Controls/Quantities);
- General Stores Inventory (Price/valuation);
- Tangible Asset Capitalisation Threshold;
- Repairable Items;
- Recognition and Depreciation of Specialist Military Equipment;
- Leave Balances for Civilian and Military Annual and Long Service Leave;
- Site Restoration Provisions;
- Specialist Military Equipment Decommissioning;
- Embedded Derivatives;
- Cashflow Statement (other than derived);
- Free of Charge Agreements between Defence and the DMO;
- Heritage and Cultural Assets;
- Reporting Entity - Consolidation of DMO;
- Disclosure and Validation of Executive Remuneration Note;
- Not-in-Catalogue; and
- Assets Now Recognised/Written-Off/Written-Down.<sup>92</sup>

2.104 As at 30 June 2007, the ANAO reports that the number of position papers they had received was now over 30.<sup>93</sup>

---

92 Department of Defence, sub 4, pp 45-47.



2.105 The ANAO is supportive of these position papers. For example, in relation to financial statement preparation for 2005-06, the ANAO states:

The development of these position papers and the consultation process between Defence and ANAO to address and resolve any technical issues and points of clarification arising was viewed as a contributing factor to the successful completion of the financial statement preparation and associated audit.<sup>94</sup>

2.106 And, further, in relation to the 2006-07 financial statements:

The ANAO supports Defence's initiative in using the position paper process as a basis for resolving accounting issues to the 2006-07 financial statements.<sup>95</sup>

#### Committee comment

2.107 The Committee is very supportive of the ongoing development of positions papers to clarify key issues and facilitate dialogue with the ANAO. However, the Committee also concurs with the view expressed by the Auditor-General that while sympathetic to the challenges Defence faces in adopting the AEIFRS, the underlying causes of Defence's financial management issues should not be construed as a problem with accounting standards per se:-

I think the accounting standards have actually highlighted that Defence has some underlying systems issues. It is a signal that attention needs to be given not so much for financial reporting purposes but because Defence needs to know the quantities of inventory it has, where they are, where all the repairable items are and all of that...the accounting standards and reporting are highlighting a problem.<sup>96</sup>

#### Summary of progress on remediation program

2.108 There is little doubt that the senior leadership at Defence is pleased with the progress that has been made in relation to financial reform, as illustrated by the following quote from Mr Nick Warner, the current Secretary of the Department of Defence:

---

93 Australian National Audit Office, Audit Report No. 51 2006-07 *Interim Phase of the Audit of Financial Statements of General Government Sector Agencies for the Year Ending 30 June 2007*, p 112.

94 Australian National Audit Office, Audit Report No. 15 2006-07 *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 102.

95 Australian National Audit Office, Audit Report No. 51 2006-07 *Interim Phase of the Audit of Financial Statements of General Government Sector Agencies for the Year Ending 30 June 2007*, p 112.

96 Mr Ian McPhee, transcript, 17 August 2007, p 19.

I have been enormously pleased with the quality of the financial work that is done in the department...I think great strides have been taken there in the last few years...<sup>97</sup>

2.109 In particular, there has been significant progress made on the remediation plans. On 13 June 2007, the Committee was advised by representatives from the ANAO as follows:

...there was a range of qualification issues last year that were effectively remediated as part of those 16 plans by the department, including those around the civilian and military annual leave records and qualification we had had in prior years. Also to the extent of remediating the issues around explosive ordnance pricing and the completeness of infrastructure, plant and equipment, all of which were qualifications in previous years. So there has been some quite significant success from the remediation plans.<sup>98</sup>

2.110 Perceptions further afield are also positive on this front. Dr Mark Thomson, although giving evidence in a private capacity, a former Defence employee and now Program Director with the Australian Strategic Policy Institute, stated:

The situation in Defence today, having begun with the low base in 2001-02, is one of extensive reform. There is a financial controls framework in place, there is a big program in place to remediate the information technology systems within the organisation, and training and skilling has been pushed right through the organisation, in particular in the financial area. This is backed up by a comprehensive plan that is being run like a project.<sup>99</sup>

2.111 Early in the inquiry, the Auditor-General too highlighted the efforts of senior management in financial reform:

...to be fair to the existing secretary and department, there has not been a stronger emphasis put on financial management than what we are seeing today. So it is a credit to the secretary and his senior colleagues...<sup>100</sup>

---

97 Mr Nick Warner, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 30 May 2007, p 46.

98 Mr Michael White, transcript, 13 June 2007, p 2.

99 Dr Mark Thomson, transcript, 8 February 2007, p 2.

100 Mr Ian McPhee, transcript, 17 August 2006, p 4.

2.112 At the public hearing on 13 June 2007, Mr McPhee went further:

...I make the positive comment that the work that Defence has done on financial management remediation is demonstrating forward progress in terms of that aspect of their administrative responsibilities and the fact that the audit qualifications, while remaining on their financial statements, nevertheless are less severe than they have been in prior years is a positive sign for Defence of forward progress.<sup>101</sup>

2.113 However, it should be noted that not all the evidence gathered in relation to progress on Defence's financial reform agenda is positive. Mr Ian Matthews, a former Director for Specialist Military Equipment with Defence during 2005, provided the following comment on Defence's financial remediation activities:

In summary, the remediation plans are like a football match where the players are yet to work out where the goals are. There is a lot of activity going on, certainly a lot of hand balling, but there are not many goals being scored.<sup>102</sup>

He added further:

There are a lot of good people within Defence putting a considerable amount of effort into these plans. Many are achieving good results in difficult circumstances. However, often these goods results are either overturned or ignored by senior management.<sup>103</sup>

2.114 The Committee also received a confidential submission from another Defence employee who was similarly sceptical about Defence's overall commitment to financial reform.<sup>104</sup>

2.115 Despite some evidence expressing scepticism about the Department's capacity for financial reform, the Committee is satisfied that Defence's objective position in relation to its financial statements has improved significantly since the implementation of the financial remediation program. The Committee acknowledges the extensive effort of the Department to significantly improve what had clearly been an unacceptable state of financial affairs in previous years.

---

101 Mr Ian McPhee, transcript, 13 June 2007, p 2.

102 Mr Ian Matthews, sub 1, p 9.

103 Mr Ian Matthews, sub 1, p 9.

104 Name withheld, sub 10.

## Defence Management Review (DMR)

2.116 The Committee notes that since the establishment of the remediation program, Defence's financial management has also received attention in the *Report of the Defence Management Review 2007*, released on 5 April 2007.<sup>105</sup>

2.117 Chapter 7 of that report provides a number of recommendations that underscore Defence's obligation to maintain the current focus on financial management. These are set out as follows:

The Review team recommends that Defence:

R30 Maintain the focus on financial management and financial systems reform. [7.6]

R31 Ensure that Defence develops and maintains the skill-sets and capabilities to enable a robust resource management system in an environment where resource certainty is reduced. [7.16]

R32 Maintain a focus on the real long-term cost of Defence. [7.16]

R33 Use the proposed audit and risk subcommittees to keep the senior leadership focused on financial reform and risk management. [7.17]

R34 Encourage the ANAO, in reviewing Defence, to adopt a performance-oriented approach and contribute its expertise and skills to the resolution of issues it identifies.<sup>106</sup>

2.118 The Committee notes evidence provided by Mr Nick Warner, Secretary, Department of Defence, to an Additional Budget Estimates hearing before the Senate Standing Committee on Foreign Affairs, Defence and Trade on 20 February 2008 that implementation of the DMR's recommendations agreed to by Defence is now in train:

We have implemented a third of the fully or partially agreed Defence management review recommendations and CDF and I aim to have the remaining two thirds implemented by 1 July this year.<sup>107</sup>

---

105 The Hon Dr Brendan Nelson, *Defence Management Review*, media release, 5 April 2007.

106 Department of Defence, *Report of the Defence Management Review 2007*, p 65.

107 Mr Nick Warner, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, p 19.

...

...16 of the 52 fully or partially agreed review recommendations have been implemented and the rest are well underway.<sup>108</sup>

2.119 On 10 June 2008, Mr Warner further reported:

All of the agreed 52 recommendations of the Proust Review will be implemented by the end of this year.<sup>109</sup>

#### Committee comment

2.120 The Committee reiterates the importance of Defence maintaining a focus on financial management and financial systems reform as recommended by the Defence Management Review (R30). This involves the Department ensuring that it regularly report progress on its financial remediation and financial systems reform agenda clearly and comprehensively until such time as Defence has reached its goal of being recognised by the Government as "...highly competent, professional and business-like financial managers within the next five years".<sup>110</sup>

2.121 With regard to R34, the Committee also makes note that the Auditor-General corresponded with the then Minister for Defence, the Hon Dr Brendan Nelson MP in April 2007, in particular in response to Recommendation 34 which he perceived to be implicit criticism of the ANAO.<sup>111</sup> Mr McPhee wrote:

It is not clear from the report the basis on which this comment was made. As you know, the ANAO has a statutory role to report on Defence financial statements and performance. In addition, it contributes to better public administration through recommendations in its reports, publications of Better Practice Guides, and its newsletter, *AuditFocus*. In the case of Defence, my office has made many recommendations for performance improvement which have been accepted and implemented by the department. Further, the ANAO has contributed significantly to the work of a range of Defence committees; has made presentations to Defence courses; and has been available to assist, as appropriate, in improving the administration of Defence.<sup>112</sup>

---

108 Mr Nick Warner, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, p 20.

109 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008, p 13.

110 Department of Defence, sub 4, p 12.

111 Mr Ian McPhee, correspondence, 13 April 2007.

112 Mr Ian McPhee, correspondence, 13 April 2007.

- 2.122 The Committee strongly supports the key contribution the ANAO makes in providing objective reports to Parliament across a wide spectrum of public administration matters including those related to the Department of Defence.

## Defence Business Improvement Board

- 2.123 At the same time the Defence Management Review was announced, Defence also announced the establishment of a Defence Business Improvement Board (DBIB). The DBIB is comprised of four non-Defence members and four Defence members.
- 2.124 Under its terms of reference the DBIB is to foster continuous productivity improvement within Defence and to report to the Secretary and the Chief of the Defence Force (CDF) on Defence corporate support improvement issues.
- 2.125 The Committee notes that the Defence Management Review provided direction, in the form of a report recommendation, on the work program of the DBIB as follows:

The Defence Business Improvement Board concentrate on specific improvement initiatives that emerge from this Review, specifically:

- Defence governance structures, including Charters [Recommendation R7];
- improvements to [Customer Supplier Agreements] and [Service Level Agreements] [Recommendation R10];
- improvements to costing [Recommendation R12];
- the level of staffing of the HR function [Recommendation R24];
- the impact of churn on senior positions, and identification of those that need longer tenure [Recommendation 27]; and
- business skilling [Recommendation R29]. [9.12]<sup>113</sup>

- 2.126 The Committee believes the DBIB may provide the forum for what one industry representative, BAE Systems Australia Limited, describes as an independent CFO 'peer review':

It may be helpful to involve CFO from some of the major defence companies in Australia to assist Defence in reviewing/challenging its remediation plans, in monitoring progress against plans and

---

113 Department of Defence, *Report of the Defence Management Review 2007*, p 82.

generally providing an independent sanity check/sounding board. We would be happy to be involved if requested...<sup>114</sup>

- 2.127 The Committee draws this point to the attention of the DBIB for their consideration. Additionally, the Committee believes Defence should draw upon the expertise not only of Defence industry but also non-Defence industries to modernise their management systems.

## International comparisons

- 2.128 One of the Committee's interests in conducting this inquiry was to determine how Australia's Department of Defence fared against comparably governed countries in terms of financial management.
- 2.129 In its submission Defence provided a number of tables comprising information as to international comparisons. These included an overview of the financial reporting challenges facing four selected international defence organisations (i.e., New Zealand, the United Kingdom, the United States and Canada) and a series of tables outlining each country's respective financial reporting requirements (see Appendix E).
- 2.130 To demonstrate its progress in financial reform compared to the four nominated overseas defence organisations, Defence provided the following analysis:
- To date, only Australia and New Zealand have decided to implement IFRS in the public sector. While the public sector will be required to implement the requirements in New Zealand, this compliance will not be required until 30 June 2008. Australia is required to implement AIFRS (the Australian equivalents to the International Financial Reporting Standards) in 2005-06.
  - In the United States, the Department of Defense has self-disclaimed its own financial statements for many years, and in response the Comptroller General has decided not to audit the Department due to continued Department-wide control weaknesses across significant financial and administrative areas. It is unclear when the Department of Defense will produce auditable financial statements.
  - The Ministry of Defence in the United Kingdom has undertaken a number of initiatives to improve its financial management and reporting. These initiatives were undertaken with a view
-

to improve the reliability of financial statements and to remove audit qualifications it had received in previous years. The Ministry of Defence has been successful in improving its financial management and reporting, and has subsequently obtained an unqualified audit opinion from the Comptroller and Auditor General. Defence currently has programs in place that are consistent with those the Ministry of Defence has undertaken over the last few financial years.

- The Department of National Defence in Canada prepares financial statements on a stand alone basis but financial statements are audited by the Auditor General of Canada on a whole-of-government level. The Department of National Defence is not required to apply full accrual accounting or implement IFRS. It is not clear when full accrual accounting will be applied or when IFRS will be implemented.
- The maintenance of appropriate financial and administrative records in respect of inventory is a key challenge for each defence organisation and is indicative of the complex nature and extent of the operations of defence organisations.<sup>115</sup>

2.131 It appears from this evidence that comparisons between Defence organisations internationally are not easy to make. This is complicated by the sheer scale and diversity of the business conducted under the umbrella of the Defence organisation. However, Defence argues that the financial reporting requirements for the Australian Department of Defence are at least, if not more, significant than those in other comparable countries.<sup>116</sup> For example, Australia appears to be the only Defence organisation required to prepare financial statements as a stand alone agency, implement AEIFRS, in the face of five specific accounting challenges (i.e., challenges maintaining inventory records, required to maintain employee leave entitlements records for long term, required to report embedded derivatives, required to provide for restoration and decontamination, and required to recognise and value heritage and cultural assets) (see Appendix E).

2.132 The difficulty in making international comparisons with regard to financial management is reaffirmed by the Auditor-General in response to questioning about audit practices of his overseas counterparts:

I notice quite a difference in the financial statement reports provided by auditors-general or their equivalents overseas. The US seems to have a similar situation to Australia's, with a heavy disclaimer on the state of the financial statements. The UK, on the

---

115 Department of Defence, sub 4, p 62.

116 Department of Defence, sub 4, p 62.



other hand, has in the last year provided a clear opinion, which indicates that the systems and processes and the compliance with the requirements set by the Treasury have been met to all material extent. The common feature, though, is that all defence departments seek to prepare financial statements to a lesser or greater degree.<sup>117</sup>

- 2.133 Notwithstanding the information provided above, the Committee was in receipt of no independent, objective evidence that speaks to relative best practice in financial management across Defence organisations internationally. However, the Committee agrees with the view that the problems experienced by Defence in this country are not restricted to the Australian context. The Committee also agrees that comparisons between Defence organisations internationally are difficult to make given the diverse nature and responsibilities of the organisations involved.

## Conclusions

- 2.134 The Committee commends Defence for the considerable effort that has been made in the remediation program including the remediation plans, the development of the financial controls framework and the extensive financial training regime that has been established. It is clear this work has resulted in a significant improvement in Defence's financial statements position for the years 2005-06 and 2006-07. The Committee recognises that this outcome has been achieved in the context of a number of complexities, in particular during the Department's transition to the AEIFRS.
- 2.135 However, without detracting from the substantial and positive progress that has been made towards improving the Department's financial management practices, the Committee is somewhat disappointed in the lack of consistency in reporting financial reform progress, in particular with regard to documenting the completion of individual remediation plans. This point is made against a background of persistent concerns raised during the inquiry about a lack of transparency and consistency in reporting information across Defence more generally and is addressed further in Chapter 5.

---

117 Mr Ian McPhee, transcript, 17 August 2006, p 3.

- 2.136 Additionally, the Committee believes that more attention should be paid to measuring the results of the significant investment that has been made into financial training. For example, it seems clear that one important element of the Defence's remediation program is to ensure a cultural shift so that all Defence employees recognise and appreciate the important role they play in bringing the financial management of the Department up to a standard of excellence. Measuring such a shift requires more than the simple computation of the number of people who have undertaken financial skills training.
- 2.137 Overall, the Committee agrees with the cautiously optimistic views expressed by the ANAO and those reported by the Defence Management Review that while significant strides have been made in financial reform, Defence must not take its 'eye off the ball'. Defence must build on its gains and retain a strong focus on developing a robust financial management framework to take the Department into the future.

## The Kinnaird reforms

### Background

- 3.1 On 12 December 2002, Senator the Hon Robert Hill MP, the then Minister for Defence announced the appointment of a review team, chaired by Mr Malcolm Kinnaird AO, to identify and address key challenges associated with the procurement process for major acquisitions in Defence.<sup>1</sup> On 15 August 2003, the report of the Defence Procurement Review 2003 ('the Kinnaird Review') was released.
- 3.2 The report of the Kinnaird Review covered the whole of the defence capability cycle, from initial strategic assessment to retirement of capability from service. The findings and ten major recommendations of the Kinnaird Review were arranged around four themes within that cycle as follows:-
- Communicating with government: Matching capability to strategy;
  - Defining and assessing capability;
  - Managing capability; and

---

<sup>1</sup> Senator the Hon Robert Hill, *Review team to assist with Defence procurements*, media release, 12 December 2002.

- Procuring and supporting Defence equipment.<sup>2</sup>

- 3.3 In September 2003, the Government announced that it broadly accepted the recommendations of the Kinnaird Review with the exception that the DMO would become a prescribed, rather than an executive, agency.<sup>3</sup>
- 3.4 In September 2005, the Joint Standing Committee on Foreign Affairs, Defence and Trade (JSCFADT) included in its *Review of the Defence Annual Report 2003-04* a progress report on the procurement reforms within Defence. On the basis of that review, the Chairman of the Defence Sub-Committee, the Hon Bruce Scott MP made the following comment in the Foreword:-
- The Committee found mixed progress on major procurement projects but overall noted significant improvement to the process by which capability requirements are identified and briefed to Government.<sup>4</sup>
- 3.5 More specifically, the JSCFADT noted that significant progress had been made by Defence in the implementation of the reforms such as the establishment of the Capability Development Group (CDG) and structural changes to the DMO, improved performance on recent projects (e.g., Airborne Early Warning and Control aircraft, Tiger helicopter<sup>5</sup>, and the Australian Light Armoured Vehicle), and the development of a more realistic relationship between the DMO and industry.<sup>6</sup>
- 3.6 However, the JSCFADT also flagged a number of on-going issues. These included the varied results of progress on major acquisition projects - particularly 'legacy'<sup>7</sup> projects, the high risk associated with demanding requirements for systems integration projects, and the potential pressures resulting from the proposed reforms on staffing within the Australian Defence Organisation.<sup>8</sup>

---

2 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p iii-ix.

3 Department of Defence, sub 4, p 83.

4 Joint Standing Committee on Foreign Affairs, Defence and Trade, *Review of the Defence Annual Report 2003-04*.

5 See Chapter 4 for discussion on this project.

6 Joint Standing Committee on Foreign Affairs, Defence and Trade, *Review of the Defence Annual Report 2003-04*, p 13-14

7 See Chapter 5 for discussion on terms such as 'legacy'.

8 Joint Standing Committee on Foreign Affairs, Defence and Trade, *Review of the Defence Annual Report 2003-04*, p 13-14

3.7 Two years have elapsed since the tabling of the JSCFADT *Review of the Defence Annual Report 2003-04* and over the course of this inquiry, the Committee has heard evidence that the implementation of the Kinnaird Reforms is nearing completion. In his opening address to the Committee at the first hearing of the inquiry, Dr Gumley indicated that Defence were “80 per cent of the way through”.<sup>9</sup>

3.8 More recently, Mr David Mortimer AO, Chair of the Defence Procurement Advisory Board (the body established in response to Recommendation 5 contained in the Kinnaird Review) stated:

There are 10 major recommendations of the Kinnaird reforms. I am very confident that they have all virtually been completed.<sup>10</sup>

3.9 It should be noted that as the Committee was completing this inquiry, the Hon Greg Combet MP, the current Parliamentary Secretary for Defence Procurement, announced on 7 May 2008 that a review of Defence procurement and sustainment will be conducted by Mr David Mortimer AO. Amongst other things, the Review is to consider:

Progress in implementing the 2003 Defence Procurement Review including:

- a. the implementation status of Defence Procurement Review reforms;
- b. an assessment of Defence Procurement Review reforms;
- c. actions required to complete implementation of the Defence Procurement Review reforms.<sup>11</sup>

## **Organisational implementation of the recommendations**

3.10 The Committee considered a large body of written and oral evidence on the progress and current status of the implementation of the

---

9 Dr Stephen Gumley, transcript, 11 May 2006, p 7.

10 Mr David Mortimer, transcript, 15 August 2007, p 2.

11 The Hon Greg Combet MP, *Defence Procurement and Sustainment Review*, media release, 7 May 2008.

Kinnaird Review recommendations. This evidence is presented below as per the four themes contained in the Kinnaird Review.

## Communicating with government: Matching capability to strategy

3.11 The essence of this theme in the Kinnaird Review is as follows:

Government must have information in a form that will allow it to assess the consequences of strategic decisions for defence capability.<sup>12</sup>

3.12 The first recommendation of the Kinnaird Review addresses the provision of this information:

### *Recommendation 1*

**Defence should present to government the following information in a succinct form on an annual basis:**

**an assessment of the types of contingencies Australia might face in carrying out the strategic tasks endorsed by government in Defence White Papers;**

**advice on the military force required in each contingency and the capacity of the ADF to apply this force now and in the future; and**

**advice on capability to be sustained, acquired or retired to ensure this can be achieved at acceptable cost.<sup>13</sup>**

3.13 The Defence submission to the inquiry reports progress against Kinnaird Review recommendation 1 as follows:

Defence provides this type of information to Government in many different ways as part of the information supporting the decision making process. In December 2005, the Minister for Defence released *Australia's National Security – A Defence Update 2005*. In releasing the update, the Minister noted the Government's recognition that the development of strategy is a dynamic process and that there is a need to constantly revisit strategic circumstances and adjust strategic posture.<sup>14</sup>

---

12 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p 4.

13 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p iv.

14 Department of Defence, sub 4, p 86.

- 3.14 Raytheon Australia Pty Ltd's submission reaffirmed this progress, however, they also noted that the suggestion that this reporting take place on an annual basis was unlikely to have occurred:

Process now exists for strategic reviews, although judging by the number of public versions published to date these have not occurred annually...<sup>15</sup>

- 3.15 Defence provided the following update to the Committee on 4 June 2008:

Defence provides this information annually to the Government. Defence has established a planning guidance framework which is based on the last White Paper with subsequent Strategic Updates defining the types of likely contingencies and the capacity of the ADF to apply the required military force now and into the future. Subordinate planning documents translate the Government's intent into options against the types of contingencies that may require a Defence response. This process links the strategic advice provided to Government to the delivery of capability in a structured manner.

Given the release of the *Australia's National Security – Defence Update 2007* and the relative maturity of the planning framework, the Defence Procurement Advisory Board determined that the implementation of the recommendation was completed.<sup>16</sup>

- 3.16 The Committee is satisfied on the basis of this update that recommendation 1 of the Kinnaird Review has been fully implemented.

## Defining and assessing capability

- 3.17 The initial focus of the Kinnaird Review was the actual management of major capital acquisition projects, however, as the review progressed the review team became aware that many of the problems that existed (e.g., cost over-runs, schedule delays and reduced capability) arose primarily because of poor planning in the early stages of the acquisition process.<sup>17</sup>

---

15 Raytheon Australia Pty Ltd, sub 5, p 4.

16 Department of Defence, sub 4.7.

17 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p 2.

That was probably at the heart of our recommendations – that was quite lacking in forward thinking, planning, testing. We thought that, if a third of the money that was spent fixing up problems was shifted up the front and actually got the definitions clear at the beginning – and had an unchangeable, well-tested, ‘Everybody’s happy; this is it’ – we would probably find out that the total cost of what was done was less.<sup>18</sup>

- 3.18 Problems in the early stages of capability development and acquisition had also been identified and addressed in the Senate Foreign Affairs, Defence and Trade References Committee’s inquiry into materiel acquisition and management in Defence in 2003. Indeed, a chapter of the Senate Committee’s report was devoted to capability development and acquisition. On the basis of the evidence provided to its inquiry, the Committee concluded:

One of the significant problems hindering successful project outcomes in the past has been inadequate definition of capability requirements, and poor articulation of those requirements to those responsible for acquisition.<sup>19</sup>

- 3.19 The Kinnaird Review made two recommendations in relation to defining and assessing capability:

*Recommendation 2*

**A three star officer, military or civilian, should be responsible and accountable for managing capability definition and assessment. This appointment should be on a full-time basis, with a defined tenure (minimum five years) to ensure a coherent, cohesive, holistic and disciplined approach.**

*Recommendation 3*

**Government should mandate, and enforce via revised Cabinet rules, a rigorous two-pass system for new acquisitions with government considerations dependent on comprehensive analyses of technology, cost (prime and whole-of-life) and schedule risks subjected to external verification.<sup>20</sup>**

---

18 Mr Malcolm Kinnaird, transcript, 15 August 2007, p 11.

19 Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p xi.

20 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p v.



- 3.20 It is clear from the evidence before the Committee that organisational arrangements relevant to the implementation of these recommendations have been finalised. With regard to Kinnaird's recommendation 2, the Defence submission states:

Implementation of this recommendation is complete. Lieutenant General Hurley was appointed as Chief of the new Capability Development Group in December 2003. He has a clear mandate and responsibility for managing the capability development process, including the *Defence Capability Plan*.<sup>21</sup>

- 3.21 Raytheon Australia Pty Ltd also refer to the successful implementation of this recommendation, however, in light of Lt Gen Hurley's initial appointment term of three years, they add the following:

It is too early to say whether LTGEN Hurley is fully "responsible and accountable for managing capability definition and assessment" or whether his appointment ends up being for the recommended five year minimum term to "ensure a coherent, cohesive, holistic and disciplined approach."<sup>22</sup>

- 3.22 Indeed, the Committee notes that Lt Gen Hurley's term as Chief of the Capability Development Group did not extend to five years. Lt Gen Hurley's appointment to the position of Chief of Joint Operations (CJOPS) was announced on 19 September 2007 and his subsequent promotion to Vice Chief of the Defence Force was announced on 19 March 2008.<sup>23</sup> Lt Gen Hurley was replaced by Vice Admiral Matt Tripovich as Chief Capability Development Group.<sup>24</sup>

#### Committee comment

- 3.23 While the Committee naturally endorses the idea that personnel should not be denied promotional opportunities, it strongly reiterates the importance of ensuring the position of Chief of CDG is equivalent to a three star officer and is subject to a defined tenure of at least five years where possible. The Committee presumes that the appointment

---

21 Department of Defence, sub 4, pp 87

22 Raytheon Australia Pty Ltd, sub 5, pp 4-5.

23 The Hon Joel Fitzgibbon MP, *Transcript of Defence Service Chief Appointments*, transcript of press conference, 19 March 2008

24 The Hon Dr Brendan Nelson MP, *Defence management changes*, media release, 19 September 2007.

of a new leader to this role is likely, at least in the first instance, to lead to an increased reliance on DMO support. This increased reliance has the potential to undermine the critical separation between the work of the DMO and the CDG undermining the disciplined approach envisaged by the authors of the Defence Procurement Review.

3.24 With regard to the implementation of Kinnaird's recommendation 3, Defence outlines progress as follows:

The two-pass process has been embodied in formal Cabinet arrangements with fully investigated and well argued sets of options being presented to Government since March 2004.

In addition, a higher proportion of project funds is now being spent on early analysis to provide more robust information aimed at minimising the likelihood of projects developing problems during acquisition.

More rigorous analysis is being undertaken on capability submission costings, including the fundamental inputs to capability and through life cost aspects to prevent capability being delivered without full consideration of staff or infrastructure.

The *Defence Capability Development Manual* was published in February 2005, and revised in February 2006. The manual provides authoritative guidance for Defence staff on the development of capability proposals and the role of the Capability Managers. Capability Development Group and the DMO establish emerging project teams before 'first pass' in order to provide project management support and discipline during requirements development.

A standardised project maturity score was developed in 2004 to provide an indicator of project maturity at various points throughout the capability development process.<sup>25</sup>

3.25 At the first public hearing on 11 May 2006, Lt Gen Hurley, then Head CDG, also provided the Committee with information about his responsibilities in relation to the implementation of the Kinnaird recommendations as follows:

...a number of the major recommendations that came out of the Kinnaird review were in relation to establishing my

---

25 Department of Defence, sub 4, p 89.

group, the Capability Development Group. This consolidated a number of diverse elements in the department that used to work in preparing capability proposals, business cases to go to government. We have grouped that together over the last two years, so in a sense I develop the business cases for government in a division called the Capability Systems division, which is primarily a military staffed organisation. I have an independent contestability division that looks at those arguments separately, to take a different view, to present arguments within the department to confirm the thoughts that are coming out from the Capability Systems division. I am responsible for our policies for simulation, I am responsible for our policies for test and evaluation, and I am responsible for oversight of interoperability and integration across the whole Defence Force to take a joint purview of what we are doing.

In the sense of how we move forward...we have instituted a very strong entry into the Defence Capability Plan, first pass and second pass approval process, both internally in the department, through [the Secretaries Committee on National Security] and in the [National Security Committee of Cabinet]. That is in the cabinet handbook, and we stick to that.<sup>26</sup>

- 3.26 Despite the generally positive account of the establishment of the CDG, the reforms to the two-pass process were not immune from criticism. Dr Mark Thomson, an external observer of Defence, questioned the rigour of that process:

I think one of the things that Kinnaird missed is imposing some contestability, some external scrutiny, on the decision-making processes in Defence. You can have all of the processes, all of the committees and all of the bells and whistles you want but, unless people can speak up, take a contrary view and argue the point, you will get an organisational position emerging out of the process.<sup>27</sup>

- 3.27 And, further:

Although there are quite extensive processes now detailed both for strategic guidance and for capability development in

---

26 Lt Gen David Hurley, transcript, 11 May 2006, pp 18-19.

27 Dr Mark Thomson, transcript, 8 February 2007, p 4.

Defence, we still get surprised by one-off capability acquisitions like the C17 and the expansion of Army. If these things are not flowing through the central planning process, we have got to ask just how rigorous that process is.<sup>28</sup>

- 3.28 BAE Systems Australia Limited also expressed some reticence about the integrity of the acquisition process in Defence and its impact on industry:

Despite the existence of the robust and well documented processes for capability development and acquisition, several recent major equipment acquisition projects have not complied with these processes. This short-circuiting of the system leads to uncertainty and confusion and a reluctance by industry to invest in capability.<sup>29</sup>

- 3.29 BAE Systems Australia Limited also made the point that the two pass process may not necessarily be appropriate to all acquisition projects:

The two pass process is not always appropriate, particularly to C4ISREW<sup>30</sup> projects that are more amenable to incremental spiral development and continuous improvement.<sup>31</sup>

#### Committee comment

- 3.30 The Committee notes that Government retains the discretion to waive the two pass process where necessary. Lt Gen Hurley too acknowledged that the strengthened two pass approval process served as a guide rather than a mandated requirement:

The process is there to guide government. Many of my projects go through more than two passes, and some of them go through a combined first and second pass process, depending on the knowledge of the capability, whether the solution is military off-the-shelf and what the risk is that we are taking on in bringing it in.<sup>32</sup>

- 3.31 The Committee also notes and welcomes advice that the Auditor-General is currently conducting an audit (titled *Planning and Approval of Major Capital Equipment Projects*) that will provide assurance to

---

28 Dr Mark Thomson, transcript, 8 February 2007, p 4.

29 BAE Systems Australia, sub 2, pp 7-8.

30 C4ISREW is Command Control Communications Computers Intelligence Surveillance Reconnaissance and Electronic Warfare.

31 BAE Systems Australia, sub 2, p 5.

32 Lt Gen David Hurley, transcript, 9 May 2007, p 15.

Parliament on the effectiveness of the strengthened two pass approval process introduced as a result of the Kinnaird Review in 2003.<sup>33</sup> The Committee will review that audit report to examine the effectiveness of the strengthened two pass process.

- 3.32 It appears that while recommendations 2 and 3 of the Kinnaird Review have largely been implemented a number of issues were raised during the inquiry relating more broadly to defining and assessing capability. These included a lack of clarity in the articulation of capability requirements, managing technical risk and the relationships that impact on this aspect of the capability cycle.

### Articulating capability requirements – resourcing the CDG

- 3.33 The Committee heard evidence that a lack of clarity in the definition and articulation of requirements led not only to scope-creep<sup>34</sup> and repeated contract revisions but also to the imposition of a high degree of additional financial risk for Government.

- 3.34 When asked to articulate the difficulties or concerns his organisation may have experienced with the DMO, Mr Harry Bradford, Chief Operating Officer from BAE Systems Australia stated the following:

If I look at it from a helicopter view, for me the biggest challenges are around clarity of requirements; understanding what it is that the government really wants and what the defence department really wants.

...

...the biggest difficulties...were the migration of the requirement and the difficulty industry had in responding to a changing requirement.<sup>35</sup>

- 3.35 Citing the ALR-2002 (Radar Warning Receiver) project as an illustration of these type of difficulties, Mr Bradford further stated:

...the operational requirement as it was articulated into a functional requirement specification changed continually throughout the acquisition process, so at no point was it stable. Both for the Commonwealth and for industry that

---

33 Australian National Audit Office, *Planned Audit Work Programme 2007-08*, p 48.

34 Mr Roberts, Board Director, Australian Aerospace defined scope creep in evidence to the Committee on 19 October 2006 as "...doing extra work; therefore more money.", transcript, p 26.

35 Mr Harry Bradford, transcript, 8 February 2007, p 15.

creates a great deal of difficulty because you are not quite sure what you have to build.<sup>36</sup>

- 3.36 Mr Bradford also spoke of the difficulties industry face in workforce/resource planning when the requirements of Government are unclear:

If there is a lack of clarity in industry about what the government regards as national strategic defence capabilities, then the consequences are that you do not know what to invest in. For example, if you know that there is a clear strategy to sustain the electronic warfare capability, then you would know that you had to sustain certain capabilities in industry to support that. If you do not know that, all you can do is look at the projects that are funded for allocation to industry for competition or whatever...<sup>37</sup>

- 3.37 The reasons behind the lack of clarity in assessing capability requirements appear to vary. Raytheon Australia Pty Ltd suggested that moving too quickly in the preparatory phases of acquisition is responsible for a lack of clarity in the definition of requirements:

Too often schedules are compressed and important preliminary work, such as defining requirements, is rushed and incomplete. This then flows on to the design and engineering phases, and really can be a case of more haste less speed.<sup>38</sup>

- 3.38 Moreover:

Further contributing factors to unrealistic schedules are inadequately articulated, and over-stated, requirements, and poorly understood risks associated with the technical solutions and acquisition strategies...<sup>39</sup>

- 3.39 Another consideration is that the type of project will determine the degree to which clarity in initial requirements can be achieved anyway. Developmental projects by their nature are subject to more variation than those involving off-the-shelf technology. This not only results in a higher potential for scope creep and contract variation but

---

36 Mr Harry Bradford, transcript, 8 February 2007, pp 17-18.

37 Mr Harry Bradford, transcript, 8 February 2007, p 22.

38 Raytheon Australia Pty Ltd, sub 5, p 6.

39 Raytheon Australia Pty Ltd, sub 5, p 7.

also in an intensification of financial risk for the Government. Mr Frank Lewincamp of Defence explains:

We cannot treat all categories of assets or specialist military equipment as one type because sometimes it is a proven, off-the-shelf type capability and the risk factors are very low. That is when you might have a fixed price contract or a pretty firm arrangement with the contractor. At the other extreme, you might be dealing with leading-edge technology, very complex systems integration or an international supplier or we might be on a production line in another country. You have enormous risk in all of that. Therefore, it is very difficult to have very precise contracting arrangements at the start. There needs to be a great deal of flexibility in the way that Defence and DMO approach these issues.<sup>40</sup>

3.40 At the hearing on 9 May 2007, Dr Gumley outlined how the potential for scope creep had been lessened as a result of the 'air gap' created between CDG and the DMO:

I think there is an important difference that the Kinnaird process has made here...If General Hurley's people want to change the scope of a project – say they are being pressured by Chief of Navy, Chief of Army or somebody – then it has to be done through a formal documented process rather than creep. Now it is a block change rather than a creeping type of thing. That discipline will put us in good stead for the future.<sup>41</sup>

3.41 However, Dr Gumley pointed out that variations in the scope of the project are unlikely to disappear entirely:

...it would be wrong to think that scope creep or scope change is entirely unavoidable. We are getting some platforms that take 10 years to build. When the mean life of computers is perhaps two years between microprocessor upgrades and so on, you can have obsolete systems by the time you finish a project if you do not have some scope upgrades as you work your way through.<sup>42</sup>

3.42 The Committee believes the importance of clearly defining and articulating requirements cannot be overstated. Yet the Committee

---

40 Mr Frank Lewincamp, transcript, 29 March 2007, p 14.

41 Dr Stephen Gumley, transcript, 9 May 2007, p 13.

42 Dr Stephen Gumley, transcript, 9 May 2007, p 13.

heard evidence from a number of witnesses suggesting that the Capability Development Group faces significant strain on its resources. This aspect was drawn out not only by representatives of Defence but also industry representatives. At the hearing on 9 May 2007, Dr Gumley stated:

To go to the resourcing, I think it is fair to say that [Capability Development Executive] is doing an extraordinarily large amount of work with minimal resources. We have an obligation to government to get as many of the DCP projects through the system as we can.<sup>43</sup>

- 3.43 Raytheon Australia Pty Ltd's written submission also referred to extra demands placed on the CDG following the transition to the strengthened two-stage approval process:

...the transition has placed enormous demands upon the revamped Capability Development Group (CDG) under LTGEN Hurley and this should be recognised. Once a steady state has been reached the process should be manageable, but in the intervening period CDG staff are struggling to provide the analysis and other information the process requires. The result has been that project approvals are falling behind schedule. This is accepted, but what should then follow is an appropriate adjustment to the acquisition schedule to avoid further compression that has so often beset projects in the past.<sup>44</sup>

- 3.44 At the hearing on 28 March 2007, Mr Fisher of Raytheon Australia Pty Ltd again called for the allocation of greater resources to the CDG:

To improve the process, I really believe we should provide General Hurley's team with more resources to engage industry more so that we get it right up-front. In a two-pass process, we should go to Kinnaird for first pass and say that it is \$10 for 10 weeks. Then what I like to do is spend more time with industry and the capability people working together in partnership – and they are doing this, by the way.<sup>45</sup>

---

43 Dr Stephen Gumley, transcript, 9 May 2007, p 5.

44 Raytheon Australia Pty Ltd, sub 5, p 7.

45 Mr Ronald Fisher, transcript, 28 March 2007, pp 20-21.



- 3.45 Mr Peter Nicholson of BAE Systems Australia Limited, makes a similar call:

The expertise of the staff in the capability development area is extremely high; the problem is there are not enough of them.<sup>46</sup>

It needs to be beefed up because the operational concepts are not coming out of the strategy staff in enough detail and fast enough...The Capability Development staff just needs to be beefed up.<sup>47</sup>

- 3.46 BAE Systems Australia's written submission to the inquiry also contained the following comment with regard to CDG resourcing:

The lack of human resource in CDG means, *inter alia*, that CDG must internally subcontract to DMO to perform much of the pre first pass and second pass tasks that should be carried out in CDG. This is contrary to the spirit of Kinnaird and has a serious effect on the colour of this work.<sup>48</sup>

#### Committee comment

- 3.47 It is clear from the evidence that decisions made in the early stages of the capability life cycle are critical to the long-term success of any Defence acquisition process. Ensuring that requirements are clearly articulated and communicated and that high levels of technical risk are managed effectively underpin the success of that process.
- 3.48 The Committee notes the positive comments made in submissions and by witnesses about the capacity and expertise of CDG personnel, however, the Committee also notes that an ongoing lack of resourcing to the CDG may undermine that Group's capacity to prepare business cases for project approvals. Additionally, as alluded to in the quote above (see section 3.46), the Committee notes that any increased reliance on the DMO has the potential to undermine the separation between the work of the DMO and the CDG.

---

46 Mr Peter Nicholson, transcript, 8 February 2007, p 22.

47 Mr Peter Nicholson, transcript, 8 February 2007, p 28.

48 BAE Systems Australia Limited, sub 2, p 5.

## Managing technical risk

- 3.49 The Department of Defence reports that reforms that have come about as a result of the Kinnaird Review have also improved the management of technical risk:

Probably the response to the Kinnaird review of defence acquisitions was such that [issues related to decision makers having sufficient detailed consideration of highly complex risks] were identified. The two-pass system, the level of committees, the exposure of risk and the level of discussion at cabinet are all examples of where those types of things have now been addressed and why the process is far more disciplined than it has ever been in the past.<sup>49</sup>

- 3.50 Expanding on this comment, Rear Admiral Trevor Ruting, Head Maritime Systems Division, DMO on 7 December 2006 stated:

...the arrangements that are now in place take a whole range of independent advice coming up to both senior defence committees and then further up in the much more expansive cabinet submissions to go forward for project approvals now. That includes the Defence, Science and Technology Organisation providing independent advice on the technology readiness levels, the technology risk assessments and the various mitigations which are part of the main body of the cabinet submission and then are much more detailed in what is called the acquisition business case for each of the options that has been put to government. Those acquisition business cases for something like a ship acquisition or an upgrade of the size of the FFG run typically to the order of 50-plus pages and summarise a lot of this information, with major sections addressing cost, schedule, technical and performance risks in the main body so that the senior decision-making body, our national security subcommittee of cabinet, is provided with much more extensive information. Embodied in that is independent advice from the Defence Science and Technology Organisation, which subsequently gets actively involved in observing the risk management arrangements during the life of the project as well.<sup>50</sup>

---

49 Mr Kim Gillis, transcript, 7 December 2006, p 25.

50 Rear Admiral Trevor Ruting, transcript, 7 December 2006, p 25.

- 3.51 Not all views on DSTO's contribution to reducing technical risk were positive. For example, in its submission to the inquiry, Raytheon Australia make the point that more could be done to improve the management of technical risk:

...Too often Defence specifies unique technical solutions to meet ADF requirements, seemingly without sufficient consideration of the impact upon the project's risk profile and the associated overall cost. This is an area where greater discipline is required.

Australia does face unique challenges in terms of space and distance, low force-space ratios, and different environmental conditions to those experienced in the northern hemisphere, where most equipment is designed and produced. These differences need to be considered when acquiring new capabilities, but changes to existing systems or platform designs should be rigorously tested, and the technical implications thoroughly understood, before they are approved.<sup>51</sup>

- 3.52 BAE Systems Australia was also relatively critical of the technical role DSTO plays in the approval process:

The allocation of a technical assessment role to DSTO has slowed the process between first and second pass, and from second pass to contract award with little demonstrable reduction in risk. It also diverts DSTO from its core capability of applied research and development.<sup>52</sup>

- 3.53 However, this position was disputed by both Dr Lough, Chief Defence Scientist and Lt Gen Hurley at the hearing on 23 May 2007 with Dr Lough stating:

I do not agree with their assessment.

...

I would say it is a timesaver and will help to increase the chance of the project being delivered on time.<sup>53</sup>

---

51 Raytheon Australia Pty Ltd, sub 5, p 9.

52 BAE Systems Australia Limited, sub 2, p 5.

53 Dr Roger Lough, transcript, 23 May 2007, p 13.

3.54 Lt Gen Hurley agreed:

I can say that I have not had one of my director-generals or the head of capability systems come up to me and say, 'We have to slow down the project for approval because DSTO is dragging the chain on the [technical risk assessment],' or, 'The [technical risk assessment] is taking too long...'<sup>54</sup>

**Committee comment**

3.55 The Committee believes the lack of consensus evident around the management of technical risk is worthy of further attention. This issue is of particular relevance in a context where the need for increasingly complex technology has to be balanced with Defence's obligation to ensure the Government will attain value for money with regard to its procurements.

3.56 The Committee therefore welcomes the Defence Procurement and Sustainment Review's stated potential reforms including but not limited to:

Methods to improve the planning, management and oversight of development projects involving a high level of technical risk.<sup>55</sup>

3.57 Given that the management of technical risk is critical to improving Defence acquisition outcomes, the Committee will seek a briefing of the reforms proposed by the Defence Procurement and Sustainment Review around this issue.

**Relationships**

3.58 The relationship between the CDG and the DMO, and that between Defence, DMO and industry are fundamental to the success of any Defence major acquisition process. These relationships are particularly important in the capability definition and assessment phases and they were referred to a number of times during the course of the inquiry.

3.59 With regard to the relationship between the CDG and the DMO, the Committee was satisfied from the evidence that this relationship is a

---

54 Lt Gen David Hurley, transcript, 23 May 2007, p 13.

55 The Hon Greg Combet MP, *Defence Procurement and Sustainment Review*, media release, 7 May 2008.

healthy one. For example, when asked to describe the relationship between the teams involved, Lt Gen Hurley stated:

When I first came into the job, in this appointment...there used to be an analogy that my organisation or its predecessor used to throw dead cats over a wall to DMO.

...

DMO would have to resuscitate them to turn them into capability. My original response to that analogy was, 'Well, we have to give you live cats.' But in fact the analogy is wrong. There is no wall.<sup>56</sup>

- 3.60 The relationship between the Department of Defence (or more specifically, the DMO) and industry is also an important one. Engaging industry earlier and more frequently is commonly suggested by industry representatives as a means to strengthen this relationship. For example, Mr Peter Nicholson of BAE Systems Australia Limited made the following point about the benefits of consulting industry earlier:

Industry might have ways to do stuff that the military has never thought of, and that is sometimes the case. That is why industry has to be brought in early. For example, in information operations, the best outfits in the world right now are the banks. They do it far better than any military organisation.<sup>57</sup>

- 3.61 At the hearing on 8 February 2007, Mr Nicholson took this up further:

A further contention of Kinnaird – which we would support strongly – is that industry, which has a whole range of expertise that we have touched upon, is brought into the process much earlier than it presently is. Most often – and this is changing in some areas – industry first becomes aware of what is happening when a request for tender hits the street.<sup>58</sup>

- 3.62 The call for greater industry involvement in capability development is not a new one, as can be seen from the following quote in Raytheon Australia Pty Limited's submission to the inquiry:

Although greater and more effective industry involvement in the capability development process has been something of a

---

56 Lt Gen David Hurley, transcript, 9 May 2007, p 5.

57 Mr Peter Nicholson, transcript, 8 February 2007, p 26.

58 Mr Peter Nicholson, transcript, 8 February 2007, p 23.

mantra over the last decade, and was emphasised again in the Kinnaird Review, it has proved difficult to achieve.<sup>59</sup>

3.63 Raytheon Australia goes on to explain:

The most promising mechanism, established as a result of the 1998 *Defence and Industry Strategic Policy Statement*, was the Capability Development Advisory Forum (CDAF). However, the failure of the CDAF to achieve its objective of providing industry input to the capability development process was due primarily to the failure of companies to contribute meaningful advice in the presence of their competitors. Instead the CDAF became a vehicle for industry to gain information from Defence. These failings were recognised and the CDAF was revamped in late-2005 with industry membership raised to CEO level in an attempt to meet the forum's original objectives.<sup>60</sup>

3.64 The Committee notes that on 1 March 2007, the then Minister for Defence, The Hon Dr Brendan Nelson MP, released the *Defence and Industry Policy Statement 2007*, a review of the 1998 document referred to in the above quote. Representatives of industry appear positive about this document. Commenting on its release, Mr Fisher of Raytheon Australia Pty Ltd states:

It has been well received by industry and it has been even better received by [Small and Medium Enterprises]. Major industry players make sure they look after SMEs. From our perspective, it kind of justifies why we invested in the country and why the other large multinationals invested in the country.<sup>61</sup>

3.65 More recently, the Parliamentary Secretary for Defence Procurement, the Hon Greg Combet MP, launched the key elements of Defence's Australian Industry Capability (AIC) program. These included an update to the Defence Policy Procurement Manual and an electronic version of the AIC Practitioner's Information and Tool Kit. This program is designed to ensure that Australian companies gain access to global supply chains of large prime contractors.<sup>62</sup>

---

59 Raytheon Australia Pty Ltd, sub 5, p 7.

60 Raytheon Australia Pty Ltd, sub 5, p 7.

61 Mr Ronald Fisher, transcript, 28 March 2007, p 21.

62 The Hon Greg Combet, MP, *Launch of Australian Industry Capability Program*, media release, 26 February 2008.

3.66 Similarly, on 24 June 2008, the Hon Greg Combet MP further outlined a number of initiatives designed to assist Small to Medium Sized Enterprises (SMEs).<sup>63</sup>

3.67 Mr Fisher provided evidence of improvements in the relationship between Defence and industry at the hearing on 28 March 2007:

...you should have industry helping you when you are initially developing the schedule. Before you get to DCP – we used to call it the pink book once upon a time – you should get industry in there. Under General Hurley, they are now doing this. General Hurley is saying to the CEOs that these are the projects coming up in the out years and he is then inviting us to look at them and give him ideas.

They have also introduced a thing called the RPDE – rapid prototype development environment – where they are establishing quick looks. An example is a big training solution job that is coming up. They have asked industry to come in and have a quick look at the project and see if we can measure it and do it up. The comment made there was that there are still factions within the organisation that need to embrace industry. But it works two ways; industry needs to embrace DMO more to help them establish realistic schedules.<sup>64</sup>

3.68 BAE Systems was similarly positive about the introduction of the ‘quick look’ process, however, they added the following suggestion:

Our contention is that these initiatives should be part of the normal process of capability development and acquisition rather than additions to a somewhat cumbersome and rigid procedure. In particular, RPD&E is demonstrating the value of more detailed analysis of both the perceived problem and possible solutions earlier in the cycle than is common at present.<sup>65</sup>

3.69 It is clear from evidence provided by representatives from the Department of Defence and the DMO that they believe industry is already meaningfully engaged in the pre-approval capability

---

63 The Hon Greg Combet, MP, *Combet outlines challenges facing Defence SMEs*, media release, 24 June 2008.

64 Mr Ronald Fisher, transcript, 28 March 2007, pp 14-15.

65 BAE Systems Australia Limited, sub 2, p 6.

planning process. In response to questioning about this 'complaint' from industry Lt Gen Hurley stated the following:

I think that is a lot of nonsense. I would put my hands up now and say that if industry is telling you that they do not engage with us before we come to capability approval – ...Frankly, I would say that that is rubbish.<sup>66</sup>

3.70 And, further:

The industry associations have helped us prepare functional performance specifications and the RFT. Dr Gumley and I are involved with the CEOs of industry in...the Capability Development Advisory Forum, where we lay out all that we are doing with the DCP and where we are going on issues. They engage with us on options, they engage with us in their marketing process and they come and talk to my people. I have industry in my organisation every day of the week.<sup>67</sup>

3.71 Dr Gumley added:

So what do their 500 football teams of marketing staff actually do then, if they are not engaging us?<sup>68</sup>

3.72 In its submission to the inquiry, Defence outlined a number of what it describes as *Industry-related Initiatives and Activities*. In addition to the RPD&E program described above, these included:

- *Skilling Australia's Defence Industry (SADI) Program* – to address the shortfall in the quantity and quality of skills available to industry;
- *Defence Small Business Access* – a first point of contact area to provide industry representatives easier access to Defence;
- *Defence and Industry Conference* – an annual conference held to discuss a range of issues affecting the relationship between Defence and industry;
- *Defence and Industry Study Course* – an annual national program for future leaders from industry, Defence, the ADF and other Commonwealth and State governments and agencies;
- *Publications for Defence Industry* – to provide industry with information so it can plan future investments;

---

66 Lt Gen David Hurley, transcript, 9 May 2007, p 17.

67 Lt Gen David Hurley, transcript, 9 May 2007, p 17.

68 Dr Stephen Gumley, transcript, 9 May 2007, p 17.



- *Defence Materiel Advocate* – a dedicated military officer of star-rank to help promote Australian defence industry exports and provide a link to operational experience; and
- *Capability and Technology Demonstrator Program* – a collaborative activity between Defence and industry to deliver a demonstration of the capability potential of new technology.<sup>69</sup>

3.73 Raytheon Australia Pty Limited acknowledges the effort Defence makes to engage industry as does the Auditor-General. Respectively:

...the relationship between Defence/DMO and industry is as healthy here as anywhere in the world. By and large Defence and DMO officials are open and willing to engage with companies while maintaining strong ethical standards.<sup>70</sup>

...it is important to acknowledge the energy devoted to industry engagement by Defence in the interests of improving outcomes.<sup>71</sup>

#### Committee comment

3.74 Notwithstanding the concerns of industry representatives outlined above, the Committee is satisfied that industry is in a position where it can participate fully in the capability development process. Indeed, the Committee believes that industry actively canvasses its views and promotes its capability with Government and the Department through well-resourced and powerful industry lobby groups. The Committee therefore believes it is important for key Departmental and Ministerial staff in the Defence portfolio to regularly consider industry involvement and performance, ensuring the right balance between the interests of industry on the one hand and those of the Australian public on the other is maintained.

### Managing capability

3.75 The Kinnaird Review summarises the third theme, *Managing Capability*, as follows:

Defence, and ultimately government, must be confident that they receive an accurate and comprehensive report on all

---

69 Department of Defence, sub 4, p 103-107.

70 Raytheon Australia Pty Ltd, sub 5, p 9.

71 Mr Ian McPhee, Opening statement tabled at the hearing on 13 June 2007, p 2.

aspects of capability development at each stage in the capability cycle.

Capability managers, the most prominent being the Service Chiefs, should be made responsible and accountable for monitoring and reporting to government on all aspects of approved defence capabilities. However, capability managers would not assume management responsibility in other functional areas in Defence or exercise control over budgets or funding in these areas.

To properly perform their role, the capability managers will require sound and reliable financial and budget systems within Defence. However, taking into account the present state of Defence's financial systems, transition to improved arrangements will take time, perhaps two to three years.<sup>72</sup>

- 3.76 The Committee heard very little specific evidence from Defence related to Kinnaird's recommendation 4 and few other submissions dealt directly with this, the sole recommendation, linked to this theme:

*Recommendation 4*

**Following second pass approval, the capability managers should have the authority and responsibility to report, and be accountable for reporting, on the development of defence capability. To undertake this role they should have access to all information necessary to enable them to fully inform government on all aspects of capability.**<sup>73</sup>

- 3.77 Defence's submission to the inquiry sets out progress against Kinnaird's recommendation 4 as follows:

Processes to implement this recommendation are in place but the outcomes are still to be fully demonstrated. Lieutenant General Hurley, acting on behalf of Capability Managers, presents monthly reports to the Defence Committee on the progress of approved acquisition projects in the capability Development Group. Similarly, Dr Gumley presents monthly reports to the Defence Committee and the Minister on

---

72 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, pp v-vi.

73 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p vi.

acquisition projects and sustainment activities managed by the DMO.<sup>74</sup>

- 3.78 Raytheon Australia Pty Ltd made the point that it is difficult for those outside Defence to assess the implementation of this recommendation:

It is not evident outside Defence that the Capability Managers (Service Chiefs) have been given the “authority and responsibility to report, and be accountable for reporting, on the development of defence capability”...<sup>75</sup>

- 3.79 At the hearing on 15 August 2007, Mr David Mortimer, Chair of the Defence Procurement Advisory Board, indicated that he was confident that all the recommendations of the Kinnaird Review were virtually completed, however, he also added the following comments:

If we look at the schedule of tasks that we had before us, I think there is only one minor recommendation – which is recommendation 9, the Defence financial systems – that still has some way to go. All of the others, without exception, have been completed or are signalled to have virtually been completed with some outstanding testing to be done on the effectiveness of the changes that have been introduced.<sup>76</sup>

- 3.80 The Committee notes that minor recommendation 9 refers in particular to Recommendation 4 of the Kinnaird Review.<sup>77</sup> More specifically:

[Defence] financial systems are not structured in a way that provides capability managers with a transparent view of the whole-of-life budget...<sup>78</sup>

- 3.81 The Committee is concerned by this deficiency in the implementation of the Kinnaird Review recommendations.

---

74 Department of Defence, sub 4, p 93.

75 Raytheon Australia Pty Ltd, sub 5, p 5.

76 Mr David Mortimer, transcript, 15 August 2007, p 2.

77 Correspondence between the Department of Defence and the JCPAA secretariat dated 25 August 2007

78 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p 27.

## Procuring and supporting Defence equipment

- 3.82 Kinnaird's recommendations 5 to 10 fall under the theme related to procuring and supporting Defence equipment. What follows is an outline of the progress made against each of these recommendations.
- 3.83 Kinnaird's recommendation 5 was prefaced in the Kinnaird Review as "Driving change from the top down"<sup>79</sup> and relates to the appointment of an advisory board as follows:

*Recommendation 5*

**An Advisory Board should be appointed with immediate effect, to provide advice and support to the head of the DMO and report to the National Security Committee of Cabinet on the implementation of all Defence Procurement Review recommendations.**<sup>80</sup>

- 3.84 The Committee notes progress reported against this recommendation in Defence's submission to the inquiry as follows:

The Defence Procurement Advisory Board was established in March 2004 to advise and support CEO DMO in improving the DMO. The Board generally meets monthly and provides advice to CEO DMO and reports to the Ministers for Defence and Finance and Administration on the implementation of the Defence Procurement Review's recommendations. The Advisory Board is chaired by Mr David Mortimer and consists of both private and public sector members.<sup>81</sup>

- 3.85 The Committee also notes from information provided by the Defence Procurement Advisory Board secretariat that the Board's specific role is to:

- Monitor the implementation of the Defence Procurement Review (DPR) recommendations as agreed by Government and report to the Ministers for Defence and Finance and Administration on progress;
- Provide advice and support to the CEO Defence Materiel Organisation (DMO) on strategic issues related to the direction and focus, objectives, planning, management and structure of the DMO, including how best to achieve cultural change;

---

79 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p vi.

80 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p vii.

81 Department of Defence, sub 4, p 94.

- The Advisory Board does not advise on day-to-day management issues or the management of individual projects.<sup>82</sup>

3.86 On 15 August 2007, representatives of the Defence Procurement Advisory Board gave evidence to the Committee. The Committee notes that the Board continues at the discretion of the Minister for Defence and the Minister for Finance and Deregulation. The Committee also notes that although the Defence Procurement Advisory Board currently remains in existence, the initial contract to pay sitting fees to individual board members expired at the end of March 2008.<sup>83</sup>

3.87 In response to questioning about the impact of not having a Board of this nature function any longer, Mr David Mortimer, the current Chair of the Board, expressed the following opinion:

There will be things that will not have been fully tested, so we will not know the effectiveness of some of the recommendations which have been implemented. It comes back to what I said earlier on about how deep down the changes are in the organisation and how effective the changes have been in getting the certainty that Senator Mark Bishop was asking about earlier on. Those sorts of things will be unmeasured.<sup>84</sup>

3.88 Mr Malcolm Kinnaird added:

To some extent, it is a constant improvement program that we have the chance to influence.<sup>85</sup>

#### Committee comment

3.89 The Committee was impressed with the role the Board plays in the oversight of the implementation of the Kinnaird Review recommendations and it would be concerned if the Board were disbanded and nothing were to take its place.

3.90 The Committee notes that the Department has expressed a commitment to assessing the effectiveness of the Kinnaird Review recommendations.<sup>86</sup> The Committee also notes that the recently-

---

82 Department of Defence, correspondence with Defence Procurement Advisory Board secretariat, 17 July 2007.

83 Department of Defence, correspondence to JCPAA secretariat, 3 April 2008.

84 Mr David Mortimer, transcript, 15 August 2007, p 13.

85 Mr Malcolm Kinnaird, transcript, 15 August 2007, p 13.

86 Department of Defence, *Portfolio Budget Statements 2008-09*, p 39.

announced Defence Procurement and Sustainment Review is to consider the future of the Defence Procurement Advisory Board.<sup>87</sup>

- 3.91 The Committee believes that a body should be established to measure the ultimate effectiveness of the Kinnaird Review recommendations. That is, the impact of the reforms beyond the straightforward implementation of the recommendations as suggested by Mr David Mortimer in section 3.87 above. In particular, such measurement should reflect the degree to which the Kinnaird reforms have impacted on the culture of the DMO. For example, to what extent DMO personnel see their organisation and their individual efforts at work as outcomes-focussed.
- 3.92 The objective of Recommendation 6 of the Kinnaird Review was to transform the DMO into a more business-like organisation with a clear and separate identity from Defence:

*Recommendation 6*

**The DMO should become an executive agency.**<sup>88</sup>

- 3.93 However, the Government decided that rather than an executive agency, the DMO should become a prescribed agency.<sup>89</sup> Progress against Kinnaird's recommendation 6 is reported in the Defence submission to the inquiry as follows:

The DMO became a prescribed agency under the *Financial Management and Accountability Act 1997* on 1 July 2005. Instructions and delegations have been issued by the CEO DMO as the Chief Executive of the agency. The Secretary of Defence has provided the CEO DMO with appropriate delegations under the *Public Service Act 1999*.<sup>90</sup>

- 3.94 Defence also report the organisational priorities articulated by Dr Gumley since his appointment as CEO DMO as follows:

Since his arrival the new CEO DMO, Dr Gumley, has established a new organisational structure for the DMO and

---

87 The Hon Greg Combet MP, *Defence Procurement and Sustainment Review*, media release, 7 May 2008.

88 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p vii.

89 "As a prescribed agency, the DMO is financially autonomous from Defence and is required to prepare separate and auditable financial statements. This was intended to improve the financial transparency and accountability of the DMO." Department of Defence, sub 4, p 83.

90 Department of Defence, sub 4, p 95.

filled key executive positions. He has established his key objectives for the organisation, these being:

- Professionalising staff and practices;
- Standardisation of processes and systems;
- Reprioritising DMO activities;
- Benchmarking DMO against relevant best practice elsewhere;
- Managing relationships with industry; and
- Setting the standard for change more widely in Defence.<sup>91</sup>

3.95 The Committee notes the following important comments made by the authors of the Kinnaird Review about the need for the DMO to have a distinct identity from the Department of Defence:

The transformation of the DMO into a more business-like organisation will require it to have a clear and separate identity from the Defence Department. This will bring clarity to the commercial task of delivering and maintaining defence equipment separate from broader Defence tasks.

...

It would provide the DMO with a clear separate role and identity from the department, and reinforce the need for distinct responsibilities and accountabilities...It would... provide a clear signal to staff that there will be cultural change.<sup>92</sup>

3.96 A business-like culture is naturally reflected in the behaviour of personnel. With that in mind the Committee was interested to hear that there was wide variability in the extent to which Defence personnel reflected this attribute. For example, when talking about the tender process generally, Mr Fisher of Raytheon Australia made the following point:

With regard to requests for tender documentation, it depends on the project...and the level of maturity of the person who is putting it together. Sometimes you get excellent specifications and sometimes you do not get such excellent specifications. The tender process is asking you for capability. You get a specification, and industry is sensible enough – because of dialogue we have with our customer base – to understand what the customer really wants. The specification is a

91 Department of Defence, sub 4, p 95.

92 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p vii.

guideline in some cases and in other cases it is the master template.

In the tender process we have found a mixture of some good specifications that are very strong and well put together and some specifications that are at an evolutionary stage.<sup>93</sup>

3.97 Similarly, Mr Tim Banfield from the National Audit Office of the United Kingdom, in response to questioning about what he believed was 'the ideal' form of contract said:

...it is not actually the contract itself; it is the commercial acumen of the people around and the ability to design solutions that fit specific purposes. Our Ministry of Defence was very good at having people who knew exactly which clause went where and how but were not very good at understanding what was going to motivate good performance.<sup>94</sup>

3.98 This quote draws attention to the importance of not just the technical skills of personnel but to their capacity to understand the commercial environment, emphasising the importance of fostering a business-like, outcomes-focused culture at the DMO.

#### Committee comment

3.99 The Committee strongly reiterates the importance of Recommendation 6 as articulated in the Kinnaird Review<sup>95</sup> to transform the DMO into an organisation with a culture based on performance and outcomes. However, the Committee was in receipt of little evidence that speaks to the ultimate success or otherwise of the implementation of this recommendation.

3.100 The Committee notes that the recommendation for the DMO to become an executive agency was not supported by the then Government. Moreover, the justification for this decision does not appear to have been fully articulated. The Committee anticipates that the Defence Procurement and Sustainment Review which is currently underway will consider this matter further.

---

93 Mr Ronald Fisher, transcript, 28 March 2007, p 20.

94 Mr Tim Banfield, transcript, 20 June 2007, p 8.

95 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p 33-38.



- 3.101 Recommendation 7 of the Kinnaird Review relates specifically to project management skills:

*Recommendation 7*

**Project managers should be selected on merit by the head of the DMO particularly for their project management skills. Managers could be drawn from the military, industry or the public service and they should be accountable to the head of the DMO and have minimum tenures, usually of five years. Remuneration levels should be set at the relevant level to attract and retain project management specialists.<sup>96</sup>**

- 3.102 The Department of Defence reported progress against Kinnaird's recommendation 7 as follows:

While the processes are largely in place, further work is required to ensure that all required outcomes are achieved. Project managers (both military and civilian) are selected on merit, with tenures and remuneration determined as appropriate. Under the acquisition project categorisation framework (ACAT), an interim certification system was established for project directors and managers to gain accreditation from the Australian Institute of Project Management. The interim certification system ran until December 2005 with 79 per cent of the target group taking part. The ACAT policy will be upgraded to include the requirements for ACAT I level project managers and to introduce an ACAT IV for small projects. A full certification framework is on track for introduction in December 2006.<sup>97</sup>

- 3.103 Problems with the recruitment, training and retention of skilled staff were mentioned frequently during the inquiry and evidence about the challenges in this respect as well as information about DMO's achievements in project management training at the DMO, is addressed more fully in Chapter 4.

- 3.104 Recommendation 8 of the Kinnaird Review refers specifically to the appointment of staff to the DMO:

*Recommendation 8*

**The head of the DMO should be consulted on military postings to the DMO and should have the authority to**

---

<sup>96</sup> Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p viii.

<sup>97</sup> Department of Defence, sub 4, p 97.

**accept only those ADF personnel who possess the requisite skills and experience.<sup>98</sup>**

- 3.105 In its submission, Defence reports progress against Kinnaird's recommendation 8 as follows:

Implementation of this recommendation is progressing without risk...The CEO DMO is consulted on military postings to DMO, and has the authority to accept only those personnel who possess the requisite skills and experience.<sup>99</sup>

- 3.106 Recommendation 9 of the Kinnaird Review refers to the representation of capability managers in the DMO as follows:

*Recommendation 9*

**Capability managers should have the option to locate their representatives in the DMO to monitor the acquisition and logistics management of approved capabilities.<sup>100</sup>**

- 3.107 The Defence submission reports this recommendation as complete:

Implementation of this recommendation is completed and the desired outcome has been achieved. Capability Managers were provided with this option in March 2004. They elected to pursue improvements in the current reporting process before taking up the option to provide representation. They consider that they receive sufficient information from their staff in the DMO and do not require separate representatives.<sup>101</sup>

- 3.108 The final recommendation of the Kinnaird Review, Recommendation 10, relates to project governance boards:

*Recommendation 10*

**The role of the project governance boards should be extended to include through-life-support of ADF equipment and report to the head of the DMO on potential difficulties.<sup>102</sup>**

---

98 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p viii.

99 Department of Defence, sub 4, p 98.

100 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p ix.

101 Department of Defence, sub 4, p 98.

102 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p ix.

3.109 Again, Defence reports implementation of Kinnaird's recommendation 10 as complete:

Implementation of this recommendation is completed and the desired outcome has been achieved. The role of the Project Governance Boards has been extended to cover the through-life-support function and have accordingly been renamed Materiel Assurance Boards. In addition, a number of private sector members have been appointed, including members nominated from Engineers Australia and from the Law Society of NSW. The boards provide independent advice to the CEO DMO.<sup>103</sup>

## Summary of progress on implementation of recommendations

3.110 There is a clear consensus that a considerable amount of work has been undertaken to implement the Kinnaird Review recommendations and that they are largely complete.

3.111 In its submission to this inquiry Defence provided an overview of what it considers to be the key achievements arising from the implementation of the Kinnaird Review recommendations:

- release of the Defence Update 2005, which re-evaluated the strategic environment and its impact on Defence capability;
- appointment of Lieutenant General Hurley as Chief of the new Capability Development Group in December 2003, and Dr Stephen Gumley as the CEO DMO in February 2004;
- strengthening of the 'two pass' process and the amendment of the Cabinet Handbook in relation to Defence capability decisions;
- Defence Committee reviewing monthly DMO progress on approved acquisition projects and sustainment activities;
- development of a standardised project maturity score that is used to benchmark the performance of all DMO acquisition projects;
- establishment of the Defence Procurement Advisory Board in March 2004;

---

103 Department of Defence, sub 4, p 99.

- DMO becoming a prescribed agency under the *Financial Management and Accountability Act 1997* on 1 July 2005;
- development of purchaser-provider agreements between Defence and the DMO;
- selection of project managers, both military and civilian, on merit. A certification system has been established for project directors and managers to gain accreditation from the Australian Institute of Project Management;
- signing of the Military Workforce Agreements between the CEO DMO and the respective Service Chiefs;
- establishment of the Materiel Assurance Boards to provide whole-of-life assurance on acquisition projects and sustainment activities; and
- progression of Defence financial systems reform to provide a “transparent view of the whole-of-life budget”.<sup>104</sup>

3.112 The Committee notes that Dr Stephen Gumley has since been reappointed as CEO DMO and that Dr Gumley’s employment status has been moved from a fixed term to ongoing Australian Public Service (APS) employee status.<sup>105</sup>

3.113 The Committee also notes the following comments by representatives of the Defence Procurement Advisory Board - including Mr Malcolm Kinnaird - at the hearing on 15 August 2007:

In the period that we have had a role as a defence advisory board, we have been very impressed with the work that Steve Gumley and his team have conducted – the way they have approached the tasks that have been before them with a great deal of rigour. From the perspective of an advisory board that does not play any role in the management of the organisation...it would be fair to say that some significant progress has been made. We have been impressed with the calibre of the senior management team. In the defence organisation that we are exposed to we have been impressed with the recruiting process that has been pursued to strengthen that management team over the last 18 months or so.<sup>106</sup>

As a member of the committee that produced the report that was adopted by the government, I am delighted that we have

---

104 Department of Defence, sub 4, p 84.

105 The Hon Joel Fitzgibbon MP, *Dr Stephen Gumley reappointed as Chief Executive Officer Defence Materiel Organisation*, media release, 2 May 2008.

106 Mr David Mortimer, transcript, 15 August 2007, p 1.

been able to attract the quality of people that we have attracted to the executive. They have embraced the policies that we felt were essential to start a cultural change and they are implementing our recommendations with persistence, effectiveness and, at times, courage. It is a long task because there is a large body of people who believe that their sole responsibility is to meet process. We were much more concerned with accountability and outcomes. Much of what we recommended was done so in an effort to try to shift the organisation so that it was more outcomes focused.<sup>107</sup>

- 3.114 As an external observer of Defence, Dr Mark Thomson is similarly positive about the gains that have been made:

Broadly speaking, the Kinnaird review of Defence procurement set in place a sensible set of reforms within the organisation. They have been grabbed with some gusto, and progress is being made on a number of fronts. DMO has been set up as a prescribed agency, a two-part process has been put in place for cabinet, skilling of personnel has been pushed harder and some capability for costing of capability has occurred.<sup>108</sup>

- 3.115 Industry representatives were also generally positive about the overall impact of the Kinnaird Review recommendations on the definition and assessment phases of the capability life cycle. In its submission to the inquiry, Raytheon Australia Pty Ltd states:

The two-stage approval process has been a step forward with the Government reportedly provided with much better information as a basis for their decision-making.<sup>109</sup>

- 3.116 BAE Systems Australia agrees that progress in relation to the capability development to acquisition phase of the acquisition process has been substantial, noting the following as highlights:

- The creation of the position of Chief of Capability Development Group (CCDG) at three star rank has strengthened consideration of joint and other interoperability aspects with a 'purple' advocate and champion to balance the single Service points-of-view.
- A direct consequence of establishing CCDG has been the documentation of systematic processes and procedures for

---

107 Mr Malcolm Kinnaird, transcript, 15 August 2007, p 1-2.

108 Dr Mark Thomson, transcript, 8 February 2007, p 3.

109 Raytheon Australia Pty Ltd, sub 5, p 7.

the capability development process in the Defence Capability Development Manual.

- The two pass system has introduced rigour to the process of acquiring capability and provided the opportunity for early Government scrutiny of proposals.
- The Defence Capability Development Manual and other documents provide clear guidance on the information required for the initial business case, first pass cost estimates and other important planning milestones.<sup>110</sup>

3.117 Despite these positive comments, the Committee is aware that the job of procurement reform is not yet complete. As Dr Mark Thomson reflects:

I think more needs to be done in order to get Defence procurement to where it needs to be, and there are two groups of activities that need to occur. First of all, we need more of the same. The Kinnaird reforms, by and large, pushed Defence in good directions; Defence needs to be pushed harder to continue those ongoing reforms. In particular, the approach put forward in the Kinnaird reforms concerning personnel – bringing people in from the private sector, paying people incentives and putting in place the same sorts of commercial arrangements that occur in the business world – needs to be taken further. There probably needs to be some refinement of the two-part process of project approval, and I think we are yet to fully see Defence exploit the opportunity of spending more money up front in projects to retire risk.<sup>111</sup>

3.118 Mr Peter Nicholson from BAE Systems Australia also states:

The effort has moved upstream into the capability development area with the establishment of the Chief of Capability Development, a central ‘purple’ staff, and some additional funding. But...there is a long way to go. In commercial practice, about 15 per cent of a project’s worth would generally be spent before the project starts – that is, upfront. It is nothing like that in Defence. Furthermore...the expertise is not just in the money but in the people; the right sort of people in the capability development area, and

---

110 BAE Systems Australia Limited, sub 2, p 5.

111 Dr Mark Thomson, transcript, 8 February 2007, p 3.

upstream in the strategy area. That is where the process needs to be continued and the reforms pressed home.<sup>112</sup>

3.119 Similarly, Mr Bradford from BAE stated:

The Kinnaird reforms – putting effort into achieving a greater degree of clarity with requirements at an earlier stage of the acquisition process – are extremely important, and in my view there is still not enough energy applied to that activity. There is not enough funding and there are not enough resources, particularly human resources, applied to that activity.<sup>113</sup>

3.120 In addition to the work that remains outstanding in relation to the organisational implementation of the Kinnaird Review recommendations, the Committee believes there is another key aspect that requires further attention. That key aspect relates to the more complex task of measuring the *effectiveness* of the recommendations of the Kinnaird Review.

## Measurement of reform effectiveness

3.121 Mr Mortimer indicated a high degree of confidence that all the recommendations of the Kinnaird Review had been virtually completed. However, he also added the following comments:

They are not marked by our board as having been completed because we still have the task of measuring the effectiveness of some of the outcomes... That is going to take a little bit more time. In other words, the database is not large enough for us to be able to say satisfactorily that they are all green lights.<sup>114</sup>

3.122 In this quote Mr Mortimer makes an important distinction between two key outcomes associated with the implementation of the Kinnaird Review recommendations. The first outcome is the extent to which each of the ten recommendations have, in whole or in part, been implemented structurally or organisationally across Defence. The second outcome is relevant to whether the ultimate aim of the Review, as illustrated in the quote below, has been realised:

---

112 Mr Peter Nicholson, transcript, 8 February 2007, p 21.

113 Mr Harry Bradford, transcript, 8 February 2006, p 15.

114 Mr David Mortimer, transcript, 15 August 2007, p 2.

Our approach has been to propose a number of complementary actions that, together, will bring about reforms that can provide the Government with greater certainty that the capability it has approved for the ADF will be delivered on time and within budget.<sup>115</sup>

- 3.123 Over the course of the inquiry, the Committee heard and received a great deal of evidence about the actual implementation of the Kinnaird recommendations (i.e., the first outcome above). With regard to the second outcome (i.e., the effectiveness of the Kinnaird recommendations), however, the evidence is more limited. This is largely because many of the current acquisition projects could not be considered 'post-Kinnaird'. In response to a question on when post-Kinnaird project performance audits will be tabled in Parliament, representatives from the ANAO explained:

It really depends on when the DMO starts implementing Kinnaird reforms to the new projects. At this moment most of the top projects are dealing with pre-Kinnaird.<sup>116</sup>

Kinnaird only came into effect in 2005-06 for projects. We have looked at a series of projects [including] the fleet oiler, which was a 2004 project. The tanks, which we will be reporting on next month are a 2004 project. They did not actually go through the full two-pass approval system. Many of the projects which were in the Defence capability plan in 2003-04 were deemed to be at first pass. When you talk about going through the full two-pass approval system they start with projects with a date of approval from 2005-06.<sup>117</sup>

- 3.124 In its submission, the ANAO makes plain its inability to assess the implementation of the Kinnaird reforms as yet:

The ANAO is not yet in a position to provide an authoritative view on the implementation of the Kinnaird reforms. However, the ANAO proposes to incorporate into the forward work programme an examination of post-Kinnaird activities in Defence and DMO in order to assess progress.<sup>118</sup>

---

115 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p 47.

116 Mr John Meert, transcript, 13 June 2007, p 5.

117 Mr Colin Cronin, transcript, 13 June 2007, p 5.

118 Australian National Audit Office, sub 3, p 11.



3.125 The Auditor-General at the hearing on 17 August 2006 further stated:

...we intend to put more focus on the projects that have come through the strengthened two-pass system going forward. But some of these projects are still in progress, so it is not as though the world has changed overnight... we want to develop our audit strategy to shift with the new world and see how effective some of these new reforms have been.<sup>119</sup>

3.126 As outlined above (see section 3.123) the ANAO has indicated to the Committee that performance audits of post-Kinnaird projects (i.e., projects with a date of approval from 2005-06) will be conducted:

Going forward, the ANAO will look more closely at the post-Kinnaird review activities in DMO. The ANAO will undertake a mix of audits, covering the detail of particular projects and systems, with emphasis on whole-of-life acquisition and support perspectives, and extending to looking across programmes for systemic improvements.<sup>120</sup>

3.127 The Committee notes, however, that despite what looks like a straightforward split between pre- and post-Kinnaird projects, there appears to be some ambiguity around this concept. This ambiguity often resulted in some frustration on behalf of Committee members. It appeared to the Committee that Defence often used the term 'pre-Kinnaird' as a 'stock standard' explanation of why things had gone wrong.<sup>121</sup>

3.128 The Committee therefore proposes that definitions of pre- and post-Kinnaird projects should be included in all documentation reporting on the progress of acquisition projects (see also discussion regarding a glossary to be contained in Major Projects Report contained in Chapter 5 below). Such an inclusion may provide additional useful context to ANAO performance audit reports as suggested by Mr David Mortimer:

...when you do a performance audit of the top 30 projects, if some of those are pre-Kinnaird then it would be helpful for the Auditor-General to draw your attention to the fact that it is pre-Kinnaird and for the Auditor-General to comment on

---

119 Mr Ian McPhee, transcript, 17 August 2006, pp 12-13.

120 Australian National Audit Office, sub 3, p 4.

121 For example, see discussion, transcript, 13 June 2007, p 5.

whether those issues have been addressed or whether they are still being addressed.<sup>122</sup>

3.129 As outlined in section 3.87, a further question remains outstanding in relation to the monitoring and measurement of the Kinnaird reforms. That is, the extent to which the cultural shift that the authors of the Kinnaird Review hoped would occur as a result of the recommendations is now embedded within the organisation.

3.130 This issue was raised at the hearing on 15 August 2007 by the Chair of the Defence Procurement Advisory Board as follows:

...how far we are penetrating in the organisation and what would be the best way to test it. That is one of the reasons why we are still operating as a board. One of the ways to do that may well be a survey of some kind. Another observation I have is that it is difficult for this organisation on a couple of fronts. Firstly, there is an obligation to the parliament to see that proper process is followed. You all are accountable to the public and you want, quite rightly, to hold the executive accountable to you in appropriate ways. So there is that process that is a little bit more rigorous than you would see in the private sector. Secondly, there is another issue that I notice – that is, the inability of organisations within the government sector to be as flexible with their people. I think you have got, not a resistance to change, but a certain amount of static there which you as an organisation have got to deal with. It takes a lot longer than perhaps it would in a private sector situation. So we still have to test at lower levels.<sup>123</sup>

3.131 The need for cultural change throughout Defence and the DMO was raised a number of times throughout the course of the inquiry (as indeed it had been during the Senate inquiry in 2003) and the Committee notes the importance of this aspect in relation to measuring the effectiveness of the Kinnaird Review recommendations. Cultural change is addressed further in Chapter 4.

#### Committee comment

3.132 It is the Committee's view that gaining a definitive picture of the ultimate effectiveness of the Kinnaird Review recommendations in terms of improving cost overruns, and schedule and delivery

---

122 Mr David Mortimer, transcript, 15 August 2007, p 4.

123 Mr David Mortimer, transcript, 15 August 2007, pp 5-6.

slippage, is only possible through the routine performance audits conducted by the ANAO on post-Kinnaird projects. The Committee will carefully monitor this aspect in its reviews of Defence-related ANAO performance audits.

## International comparisons

- 3.133 Under the inquiry's terms of reference, submissions were invited to comment on progress in implementing the Kinnaird reforms and achievements in procurement relative to international best practice.
- 3.134 The Committee received written and oral submissions from representatives of both Defence and industry commenting on this aspect of the inquiry. Dr Gumley from the DMO sets out his views of Australia's procurement practices compared to other international organisations below:

Based on comparisons with counterpart defence agencies overseas, we assess our efforts to improve acquisitions as being ahead of those in other countries, such as the US, UK and Canada. In Australia and internationally, DMO is leading reform in project management. Our reforms are being taken up by the Australian Institute of Project Management. DMO's focus is on achieving scheduled performance; with that will come improved cost performance. When compared with other organisations carrying out similar roles, DMO is an effective project management organisation.<sup>124</sup>

We regularly benchmark ourselves against a number of countries...[O]ne of the things that work[s] for us is the government-to-government cooperation. For example, there were the C17s, which was because of excellent cooperation between the Australian government and the US government. We are cooperating closely with the French government on this, we are working with the British and we are talking to the Canadians. It is one of the areas of the whole acquisition environment that does not get a lot of attention but, in fact, it is a key driver of success; it is also a key driver of areas where we can all improve. The benchmarking is continuous. I put charts up at my business plan review each month in DMO to

---

124 Dr Stephen Gumley, transcript, 11 May 2006, pp 7-8.

see how we compare against the British and the Americans. I have already given evidence in Senate estimates that we actually compare quite favourably with the other acquisition environments.<sup>125</sup>

3.135 At a Senate Estimates hearing on 30 May 2007, Dr Gumley also used figures on slippage to demonstrate Australia's relative position internationally as follows:

We have had slippage up around 18, 19, 20 per cent, we have had it down to 13 or 12 per cent last year, we think it is going to be about 15 per cent in the year to come. That compares roughly equally with the British and the Americans and the other major Western countries, so we are not seriously out of sync with that.<sup>126</sup>

3.136 At the same hearing, Air Chief Marshal Angus Houston stated:

...The way the DMO is going at the moment is world's best practice. Everybody in the world comes to have a look at the way we do acquisition and sustainment, because nobody does it better.<sup>127</sup>

3.137 Some industry representatives were similarly positive about Australia's relative position internationally with regard to acquisition practice. For example, based on what they say is a specific understanding of the defence market environments in United States, the United Kingdom and Canada, Raytheon Australia Pty Ltd made the following comment on Australia's position as well as suggestions for improvements:

As far as acquisition is concerned...the company believes that Australia is close to best practice in many aspects of its acquisition practices. For example, in the United States many major defence contracts are still based upon cost plus, or time and material regimes. We moved away from these forms of contracts some time ago, although as noted under the previous term of reference, we could improve the practice here by demonstrating greater awareness and understanding of the risk profiles of individual projects, or phases of

---

125 Dr Stephen Gumley, transcript, 1 March 2007, p 14.

126 Dr Stephen Gumley, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 30 May 2007, p 74.

127 Air Chief Marshal Angus Houston, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 30 May 2007, p 51.

projects, and adjusting the contract strategy accordingly. Too many developmental projects are contracted against fixed prices, to the detriment of both the Commonwealth and companies (although having some protection against unexpected cost escalation the Commonwealth ends up paying more than might be necessary because companies have to factor the additional risk into their price).<sup>128</sup>

3.138 And, further:

By our observation Australia leads the world, at least for those countries with no clearly identifiable threat, in its planning processes for structuring the ADF. The processes behind Australia's strategic and force structure planning, developed over the last thirty years, are acknowledged world-wide for their intellectual rigour and have been adapted by a number of countries.

The [Defence Capability Plan] is another area where Australia leads the world. By laying out its medium-term capital equipment acquisition plan, together with indications of the broad cost it is willing to pay in each case, the Government provides the best planning baseline for industry anywhere in the world.<sup>129</sup>

3.139 Not all submissions commenting on Australia's relative standing internationally were positive. Mr Peter Goon highlighted the anecdotal nature of the claims made in the Defence submission:

Usually, such claims would be supported by objective studies...the claims are, at best, based on anecdotal data, with the implied intent being an attempt to encourage the reader to infer 'we are better than they are'.<sup>130</sup>

3.140 A dearth of independent evidence on this aspect of the inquiry is a point not lost on the Committee. Like the evidence provided to the Committee in terms of relative international best practice in financial reform (see Chapter 2) the Committee did not receive any independent, objective evidence about international relative best practice in procurement. This does not, in and of itself, diminish the claims made in this respect, however, it does demand that caution should be applied to any interpretation of that evidence.

---

128 Raytheon Australia Pty Ltd, sub 5, p 8.

129 Raytheon Australia Pty Ltd, sub 5, p 9.

130 Mr Peter Goon, sub 7, p 2.

- 3.141 On a more positive note, the Committee believes that the lack of evidence around international best practice presents an opportunity for the Department of Defence in this country to collaborate with its counterparts in other countries to develop and document best practice around the acquisition of equipment. For example, this is particularly relevant to the fact that Australia along with the UK Ministry of Defence and the Department of Defense in the United States of America are all striving to improve the methods of reporting around major capital equipment projects.

## Conclusions

- 3.142 It is clear from the evidence before the Committee that the authors of the Kinnaird Review anticipated that their recommendations would have an impact not only on the overall effectiveness of the procurement process but on the culture of the organisation as a whole.
- 3.143 The Committee is impressed with the significant amount of work that has gone into implementing the Kinnaird Review recommendations and the Committee agrees that organisationally, the implementation of recommendations is close to completion. However, the Committee is unable to express any real certainty or comfort about the impact of the Kinnaird Review recommendations until it has had an opportunity to review the performance audits of post-Kinnaird projects by the ANAO. Until that time comments on improvements in actual outcomes such as the delivery of equipment on time and within budget and accordingly, the effectiveness of the reforms, remain somewhat speculative.
- 3.144 Likewise until a clear form of measurement of the impact of the Kinnaird Review recommendations on cultural change across both Defence and more particularly, the DMO, is available, the Committee is unable to comment definitively on the effectiveness of the reforms in this respect.
- 3.145 The Committee notes from the evidence that the early phases of equipment acquisition appear to be the most problematic, in particular in relation to the articulation of requirements and the level of financial risk the Government is exposed to. The Committee notes that changes that have occurred as a direct or indirect result of the Kinnaird Review recommendations in these early stages of the

capability lifecycle have resulted in improvements. The extent to which scope creep occurs appears to have been reduced and attempts have been made to reduce the level of technical risk associated with equipment acquisition. However, resources available to the Capability Development Group continue to be a source of concern.

- 3.146 Financial risk was a topic frequently raised over the course of the inquiry and is an aspect of equipment acquisition which remains a persistent challenge. This issue is also addressed in Chapter 4 below.
- 3.147 Evidence about a commitment to increasing the strength of the two-pass process is difficult to obtain. On the one hand, significant steps appear to have been taken to ensure that processes outlined in the cabinet handbook are adhered to, and yet recent one-off acquisitions continue to raise scepticism about the rigour of that process amongst external observers.
- 3.148 The Committee notes that relationships between Defence, the DMO and industry have improved. The evidence suggests that Defence is putting significant effort into engaging industry to a greater extent than was previously the case. However, the Committee emphasises that the balance between the capacity for industry to influence Government and the ability to ensure value for money outcomes on behalf of the Australian public must be retained.
- 3.149 While comparisons internationally were problematic, the Committee is satisfied that Defence is fully cognisant of the need to benchmark its business internationally. The Committee also believes more could be done in terms of international collaboration to improve reporting on major Defence acquisitions. To that end, the Committee is pleased to note the recent two-month secondment of Mr Warren King, General Manager Programs, DMO to the office of the US Secretary of the Navy.<sup>131</sup>
- 3.150 Once again, the Committee welcomes the announcement of the Defence Procurement and Sustainment Review. The Committee is hopeful that the review will present an opportunity for further consideration of the issues which arose during this inquiry.

---

131 John Kerin, *DMO expert to show US Navy the way*, Australian Financial Review, 10 July 2008, p 10.

## The case studies

### Introduction

- 4.1 The Kinnaird Review highlighted a number of concerns with the Defence acquisition process, in particular the frequency of cost overruns and schedule slippage. The ANAO's submission summarises the factors underpinning these problems as follows:

Recent performance audits into acquisition projects have identified significant weaknesses in project planning, including risk identification and management, as well as project costing issues. Some projects have suffered cost overruns or had scope limitations imposed for budget management reasons, and have experienced delays in implementation. Poor contract management practices have also resulted in inadequate identification and management of contractor delivery problems. Audits also identified a need to strengthen overall project monitoring and record keeping.<sup>1</sup>

- 4.2 The Fast Frigate Guided (FFG) Upgrade Project and the ARH Project Air 87 (also referred to as the Tigers) illustrate these kinds of difficulties. It is for this reason the Committee decided to use these projects as case studies for the inquiry.
- 4.3 It does not fall within the scope of this report to outline in full detail the problems associated with each of these projects. This information

---

1 Australian National Audit Office, sub 3, p 4.



is provided in published reports by the Auditor-General.<sup>2</sup> What follows instead is a brief description of the projects and a summary of the issues associated with them according to ANAO analyses.

## Fast Frigate Guided (FFG) Upgrade, Project Sea 1390

### Project background

- 4.4 The Defence Materiel Organisation describes the role of the FFGs as follows:

The role of the Surface Combatant Force Guided Missile Frigates (FFGs) is the patrol and surveillance of open ocean and coastal waters, escort and protection of ships and convoys; protection of coast shore facilities; and engagement of enemy aircraft missiles, surface ships and submarines.<sup>3</sup>

- 4.5 The Australian Navy is in possession of six Oliver Hazard Perry class FFGs, four of which were constructed in the United States (i.e., HMAS Adelaide, HMAS Canberra, HMAS Sydney, HMAS Darwin) and two that were constructed in Australia (i.e., HMAS Melbourne, and HMAS Newcastle).<sup>4</sup> The aim of the FFG Upgrade Project was:

...to regain the original relative capability of six FFGs, and to ensure they remained effective and supportable through to the end of their life in 2013-21.<sup>5</sup>

- 4.6 The FFG Upgrade Project, the second phase of Project Sea 1390, commenced in June 1999 at a cost \$1.266 billion (February 1998 prices). The prime contractor for the FFG Upgrade is Thales Australia (formerly known as ADI Limited).
- 4.7 The original project was to deliver six upgraded FFGs, however, in a review of Defence Capability in November 2003, Senator the Hon Robert Hill, the then

---

2 See Australian National Audit Office, Audit Report No. 45 2004-05, *Management of Selected Defence System Program Offices*; Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*; Audit Report No. 11 2007-08, *Management of the FFG Capability Upgrade*.

3 Defence Materiel Organisation website, viewed 20 March 2008, <<http://www.defence.gov.au/dmo/msd/sea1390/sea1390.cfm>>

4 Australian National Audit Office, Audit Report No. 45 2004-2005, *Management of Selected Defence System Program Offices*, p 62.

5 Australian National Audit Office, Audit Report No. 45 2004-2005, *Management of Selected Defence System Program Offices*, p 67.

Minister for Defence, announced that in order to provide offsets for the introduction of SM2 missiles to four of the FFGs and the acquisition of three air warfare destroyers, the oldest two of the FFGs (i.e., HMAS Adelaide, and HMAS Canberra) would be laid off.<sup>6</sup>

## Issues identified by the ANAO

4.8 In May 2005, the ANAO tabled an audit report on a number of Defence System Program Offices, one of which is responsible for the FFG Upgrade Project (ANAO Audit Report No. 45 2004-2005, *Management of Selected Defence System Program Offices*). A further audit report entitled *Management of the FFG Capability Upgrade* was tabled on 31 October 2007.

4.9 The 2005 audit examined contract management by the DMO and included information on schedule delivery, financial management and performance outcomes. On the basis of this audit, the ANAO concluded:

The FFG Upgrade Project is not proceeding satisfactorily and requires continued Defence Senior Executive attention, in order to prevent further loss of Navy capability. The FFG Upgrade Project has experienced extensive schedule slippage, and as of November 2004, 78 per cent of the contracted payments had been made without a satisfactory design and development disclosure process in place, nor agreement with important elements of the project's Tests and Trials program. ANAO considers that further slippage is likely on the lead ship, HMAS Sydney, which will have flow on effects for overall Navy capability.<sup>7</sup>

4.10 With regard to financial management, the ANAO found:

...that in the period 1999 to mid-2003, the FFGSPO financial records did not provide a reasonable level of assurance for the orderly, efficient and accountable measurement of the use of Australian Government resources. The ANAO is concerned that legislative and administrative requirements concerning the keeping of accounts and records may not have

---

6 Senator the Hon Robert Hill, *Defence Capability Review*, media release, 7 November 2003.

7 Australian National Audit Office, Audit Report No. 45 2004-2005, *Management of Selected Defence System Program Offices*, p 21.

been met for a significant period, prior to mid-2003, in relation to this project...<sup>8</sup>

4.11 As outlined above, the ANAO tabled a follow up audit of the FFG Upgrade Project on 31 October 2007. This audit reviewed the performance of the FFGSPO's management of the FFG Capability Upgrade Project.

4.12 The ANAO reported the following conclusions:-

- The FFG Upgrade Project has experienced extensive delays in meeting the contracted capability upgrade requirements specified in the late 1990s. The number of FFGs to be upgraded has been reduced from six to four, and the scheduled acceptance of the fourth and final ship has been delayed by four and a half years to June 2009. Since the last ANAO audit in 2005, the project delays are attributable to a range of Underwater Warfare System and Electronic Support System performance deficiencies. Considerable risk remains to the delivery of contractually compliant capability to Navy, given the maturity of these systems.<sup>9</sup>
- The FFG Upgrade Prime Contract is less robust than more recent Defence contracts in terms of providing DMO with adequate opportunity to exercise suitable management authority over the project's acceptance test and evaluation programme. Nevertheless, FFGSPO has monitored the Prime Contractor's performance and provided extensive feedback aimed at achieving improved visibility into the project's engineering development, testing procedures and test results. But the overall result has been long-running design review, test programme and requirements completion verification difficulties.<sup>10</sup>
- The DMO exercised discretion in Provisionally Accepting HMAS *Sydney* in December 2006 in accordance with the contract as amended by the May 2006 Deed of Settlement

---

8 Australian National Audit Office, Audit Report No. 45 2004-2005, *Management of Selected Defence System Program Offices*, p 21.

9 The Prime Contractor advised the ANAO in October 2007 that considerable work has been undertaken throughout July - October 2007 to demonstrate a contractually compliant Electronic Support System, and that independent tests are to be conducted in Hawaii during the Lead Ship deployment to provide comprehensive data noting the complexity of the Electronic Support System test environment.

10 The Prime Contractor advised the ANAO in October 2007 that the complexity of the test programme is acknowledged and it was necessary to introduce a contractual change (B-TAP) to address the inadequacies of the original contract. As a consequence the DMO now has an appropriate vehicle to address previously perceived difficulties within the Verification and Validation process.

and Release.<sup>11</sup> Consequently, at the time of its Provisional Acceptance in December 2006 HMAS Sydney had not achieved important Provisional Acceptance milestone precursors,<sup>12</sup> which are now required to be resolved before the ship's Acceptance in November 2008. As at September 2007, HMAS Sydney was experiencing continuing delays in obtaining Initial Operational Release by Navy. This is attributed to limitations in the maturity of Underwater Warfare and Electronic Support Systems and supporting documentation required to satisfy Navy's technical regulations.<sup>13</sup>

- The DMO is not well placed to exert influence over the Prime Contractor performance at this time due to the nature of the original contract, and the extent of funds already advanced. The project's liquidated damages provisions for delayed delivery are capped at less than one per cent of the contract price, and so are unlikely to provide an effective deterrent measure. The May 2006 Deed released both parties from all legal claims including liquidated damages prior to that date. DMO's election not to exercise its preserved right to seek remedies for the Prime Contractor's inability to achieve Provisional Acceptance of HMAS *Sydney* by 27 August 2005, has resulted in no liquidated damages being claimed by DMO as at September 2007.
- The FFG Upgrade Project's Earned Value Management System (EVMS), which controlled some 70 per cent of payments, has been subjected to 10 revisions of the

---

11 Achieving Provisional Acceptance does not relieve the Prime Contractor of any obligations in regard to rectifying contractual non-conformance prior to the Acceptance of each Upgraded FFG and the Contract Final Acceptance in December 2009.

12 The precursors include satisfactory completion of Combat System Stress Test, training courses for ship's company completed, and Category 5 testing [Sea Acceptance Trials] successfully completed. Also, HMAS Sydney's combat system Baseline Build 1 was experiencing 16 high, 102 medium and 218 low severity System Integration Problem Reports. The Contract's Provisional Acceptance criteria, detailed in Attachment AG is zero High Severity, 25 Medium and 685 Low Severity Problem Reports. See Tables 4.2 and 4.3 for Problem Report criteria and severity definitions. The number of Medium and Low Severity Problem Reports stated in paragraph 101 of Attachment AG are the maximum unless otherwise agreed with the Project Authority. This was the clause exercised in the Provisional Acceptance process. As such, the Contractor complied with the Contract as stipulated at Attachment AG and agreed by the Project Authority.

13 The Prime Contractor advised the ANAO in October 2007 that the discretion exercised by the FFGSPO in accepting Provisional Acceptance of the Lead and First Follow On FFGs was within the specifications of the contract. The Prime Contractor further advised that it would welcome the opportunity to present the objective quality evidence that supports a higher level of maturity of the systems delivered, including the Underwater Warfare System and Electronic Support System, than has been credited in the report.

project's Contract Master Schedule by the Prime Contractor.<sup>14</sup> The May 2006 Deed required a new Integrated Baseline Review to be undertaken by DMO to validate the most recent Contract Master Schedule change. DMO expects the Integrated Baseline Review to be completed in October 2007. The magnitude of the schedule slippage has led to DMO experiencing difficulty in determining if earned value payments were accurately tracking work performed on the project. By October 2006, the Prime Contractor had received earned value payments that exceeded actual value earned by \$24 million. DMO progressively recovered these overpayments.

- There are relatively small milestone payments remaining for the major capability deliveries ahead in the project. The milestone payments for the Acceptance of all four FFGs and the Acceptance of FFG Upgrade Software total \$11 million (February 1998 prices). This is 1.1 per cent of the Prime Contract price. The milestone payment due at Contract Final Acceptance in December 2009 is \$3.36 million (February 1998 prices), which is 0.34 per cent of the Prime Contract price.
- This audit highlights some of the challenges Defence faces in acquiring advanced capabilities for the Australian Defence Force (ADF). DMO relies on industry to deliver Defence's major capital equipment acquisition programme outcomes. If industry and DMO fail to deliver the specified capability to schedule, then invariably the ADF experiences delays in achieving the anticipated capability. In the FFG Upgrade Project's case, there is a four and a half year delay in the delivery of the final upgraded ship and an over five year delay in the delivery of the upgraded Combat Team Training facility. Project delays also result in DMO, the ADF and DMO's Technical Support Agencies carrying additional costs associated with maintaining and supporting DMO's project teams for longer, and at greater skill levels, than originally anticipated.<sup>15</sup>

---

14 The Prime Contractor's Contract Master Schedule is an important component of the Earned Value Management System. It establishes the FFG Upgrade Project's key dates and hence is required to be completely compatible with and traceable to the Contract's Milestone Schedule, and be meaningful in terms of the Contract's technical requirements and key activities.

15 The Prime Contractor advised the ANAO in October 2007 that the reference to the DMO requiring "greater skill levels than originally anticipated" is a reflection of the fact that the complexity of the contract was not well understood at the outset. This was exacerbated by the necessity to expend additional effort to comply with operational, technical and training regulatory frameworks introduced after contract signature.

- Another challenge highlighted by this audit is the need for DMO to establish contractual frameworks that encourage and require contractor performance through appropriate contractual performance management and progress payment regimes. In the case of the FFG Upgrade Project, the contract did not provide DMO with sufficient contractual leverage over the contractor, in terms of approval rights over the project's test and evaluation programme, nor did its liquidated damage provisions effectively discourage variations to contracted delivery schedules. The FFG Upgrade Project demonstrates that once major Defence capital equipment contracts are entered into, the prospects for DMO overcoming inadequate provisions are fairly limited. Since the FFG Upgrade Prime Contract was signed in June 1999, DMO has taken steps to achieve better contract provisions for test and evaluation and requirements verification.<sup>1617</sup>

## **Tiger Armed Reconnaissance Helicopter (ARH) Project – Air 87**

### **Project background**

- 4.13 ARH Project Air 87 ('the Tigers') involves the acquisition of armed reconnaissance helicopters and associated support infrastructure to replace the capability currently represented by the Bell 206B-1 (Kiowa) and UH1-H (Iroquois) gunship helicopters.
- 4.14 The acquisition includes the delivery of twenty-two helicopters with supporting stores, facilities, ammunition and training equipment. The aircraft are manufactured in France by EADS (a company which also builds civilian aircraft such as the A380 Airbus), however, eighteen of the aircraft are to be assembled in Brisbane.<sup>18</sup> The ANAO

---

16 Verification is defined as the process of determining whether or not the products of a given development phase fulfil the requirements established during the previous phase. Verification confirms that the products properly reflect the requirements specified for them.

17 Australian National Audit Office Audit Report No. 11 2007-08, *Management of the FFG Capability Upgrade*, pp 18-21.

18 Australian National Audit Office, Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, p 11.

reports that initial flying instruction for Australian Army Flight Instructors is undertaken by the contractor in France.<sup>19</sup>

- 4.15 In 2005-06, this project, with an approved budget of \$1.96 billion, was budgeted to have the largest capital expenditure (totalling \$440 million) of all the DMO's projects.<sup>20</sup> The acquisition of the Tigers was considered to be an 'off-the-shelf' procurement, representing a low risk to Defence.<sup>21</sup>

## Issues identified by the ANAO

- 4.16 On 2 May 2006, the ANAO tabled Audit Report No. 36, 2005-2006, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*.
- 4.17 The purpose of the audit was to assess the effectiveness of DMO's and Defence's management of this procurement. The audit is described as follows:

The audit reviewed the initial capability requirements and approval process; analysed the contract negotiation process; and examined management of the Acquisition and Through-Life-Support contracts.<sup>22</sup>

- 4.18 A summary of the overall conclusions of the ANAO is as follows:
- the ARH aircraft was to have been an 'off-the-shelf' delivery of proven, operational technology. It instead became a more developmental program for the ADF, resulting in greater schedule, cost and capability risks;
  - original cost estimates for through-life support were immature, as there was a lack of operational experience in maintaining the capability in other Defence forces. This exposed Defence to significant future budgetary risks;

---

19 Australian National Audit Office, Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, p 90.

20 Australian National Audit Office, Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, p 13.

21 The ANAO reports Defence definition of off-the-shelf as "...a product that will be available for purchase, and will have been delivered to another Military or Government body or Commercial enterprise in a similar form to that being purchased at the time of the approval being sought (first or second pass)". See Australian National Audit Office, Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, p 11.

22 Australian National Audit Office, Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, p 36.

- at October 2005, DMO had expended \$855.45 million on the project, representing payment for four of 22 aircraft, design work, and a proportion of external stores, facilities, training deliverables and the required support equipment. Of this expenditure, \$731 million had been expended on the Acquisition Contract, representing around 60 per cent of the total value of this contract;
- twelve months after accepting the first two production aircraft (ARH1 and ARH2) in December 2004, the ADF did not have an effective Tiger ARH capability and had limited ability to train aircrews;
- at the time of acceptance of ARH5 in June 2005, the aircraft was not fit for purpose against all the contracted requirements (as was the case with the first two aircraft). The DMO accepted the aircraft in a state that did not meet contractual requirements but did not withhold part payment;
- the DMO advised the ANAO that it had accepted that the aircraft would not meet the fully contracted specification and had agreed to a lesser capability at the In-Service and acceptance dates of the first three aircraft. The ANAO found that the resulting remediation plan was not formalised through agreed Contract Change Proposals; and
- in addition to contractual shortfalls, the first three aircraft were accepted by the DMO with significant capability limitations, including deficient elements of the weapons, engine and software systems. Deeper level maintenance and retrofit activity to ameliorate deficiencies with the first aircraft commenced in February 2006 and were to be completed by November 2006.<sup>23</sup>

## Key concerns

4.19 The Committee heard a great deal during the inquiry that demonstrated a number of problem areas in Defence procurement processes. These included: a lack of rigour in project/contract management practices; poor inventory management; a reticence in enforcing contract provisions; problems around the use of the term

---

<sup>23</sup> Extracted from Australian National Audit Office, Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, pp 16-18.



military-off-the-shelf; risk allocation; the recruitment, training and retention of personnel; and documenting lessons learnt.

- 4.20 The Committee recognises that these issues, having been raised on a number of occasions in a variety of fora, come as a surprise to no-one. However, their persistence demands they be re-stated with a view to identifying where progress has been made since the Kinnaird Review and where challenges remain.

### Lack of rigour in project/contract management

- 4.21 The Committee was made aware of a number of examples of poor contract management across both the FFG Upgrade Project and ARH Project Air 87. For example, an issue of particular concern to the Committee related to payments being made under the Earned Value Management System<sup>24</sup> prior to that system being approved. Specifically, in a briefing to the Committee, the ANAO reported:

The project's Earned Value Management System's Performance Measurement Baseline was approved in mid 2000, with the payment of two milestones. However, during the period December 1999 to June 2000, the ADI was paid \$88.9 million in earned value payments.

The Earned Value Management System did not receive specification compliance certification until November 2001, by which time more than \$200 million had been paid in earned value payments.<sup>25</sup>

- 4.22 Mr Colin Cronin of the ANAO referred to consequences associated with payments such as these in the hearing on 13 June 2007:

...In the FFG process, within six months of the signing of the contract [Defence] started to pay out massive amounts of earned value payments before they actually had an approved earned value system. If you have not got an approved earned

---

24 Under the Earned Value Management System (EVMS), performance or progress is measured against the schedule terms on a monthly basis. Each month an earned value claim is made, the Department of Defence assesses the validity of the claim and once validated, the claim is paid. Milestone payments are where contractors are paid an initial mobilisation payment and thereafter payments are made on completion of agreed milestones. See discussion on EVMS, transcript, 12 October 2007, pp 3-4.

25 Australian National Audit Office, briefing, 12 October 2006.

value system how do you know that the earned value that has been reported to you is valid?<sup>26</sup>

- 4.23 A lack of concern with the requirement for formal process was further evident in lax practices around the documentation of contract changes. For example, in relation the ARH Project Air 87:

The ANAO observed that the negotiation for a fundamental change to the Acquisition Contract to cater for the resulting remediation plan that impacted on available operational capability, was not formalised through agreed Contract Change Proposals.<sup>27</sup>

- 4.24 At a Budget Estimates hearing in May 2007, Mr Cronin highlighted ongoing difficulties with Defence maintaining current versions of contracts:

A problem that has occurred in a number of audits is related to the notion of contract management. In the process of contract management you need to maintain a current contract. The maintaining of a current contract is central to the management of that contract...making sure that you have a current contract, making sure that you are paying in accordance with the contract and making sure that you are getting deliveries in accordance with the contract...<sup>28</sup>

- 4.25 Mr John Meert of the ANAO reaffirmed the importance of following formal process when he said:

You cannot just rely on the individual because they do come and go, so you basically have to rely on the systems. Where is your project management data? Where are the analyses on the capability and the payments? That should be there on record. It is like the Tiger; all the acceptances should be done in a formal process. It is not a haphazard process.<sup>29</sup>

- 4.26 In addition to poor project/contract management practices such as those outlined above, the Committee was concerned with an apparent lack of rigour in the management of the tender process associated with the acquisition of the Tigers. This was illustrated by what

---

26 Mr Colin Cronin, transcript, 13 June 2007, p 7.

27 Australian National Audit Office, Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, p 17.

28 Mr Colin Cronin, Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 22 May 2007, p 165.

29 Mr John Meert, transcript, 13 June 2007, p 9.

appears to have been the acceptance of an immature estimate in relation to through-life-support (TLS) costs on the Tigers, leaving the Government exposed to significant financial risk.

- 4.27 The ANAO reported that in December 2001, Defence signed an Acquisition Contract of \$1.1 billion and a TLS Contract with Eurocopter International Pacific (now known as Australian Aerospace Limited) with a fixed price element of \$410.9 million.<sup>30</sup>
- 4.28 The ANAO also reported that Eurocopter International Pacific won the contract largely on the basis of their affordability in terms of acquisition and TLS costs. Eurocopter's largest comparative cost advantage related to their TLS element which was approximately one-third less than the nearest competitive bid. However, subsequent to winning the bid, the contractor reviewed the TLS costs and made a request to increase the TLS payments by an additional \$365 million (or \$625 million applied over 15 years).<sup>31</sup>
- 4.29 The Committee was keen to understand what had occurred in relation to the review of the TLS contract and questioned both the contractors and Defence extensively on issues related to this matter.
- 4.30 The large variation between the original TLS contract price and the subsequent estimate of the TLS costs raised Committee concerns first, about the extent to which care had been taken to determine an accurate contract figure and subsequently about the integrity of the original tender process as a whole.
- 4.31 With regard to the immaturity of the estimate of the TLS costs, the Committee was provided with the following explanation by a representative of the contractor, Aerospace Australia, Mr Joseph Saporito:

At the time of initial discussions with DMO and signing the contract we were aware the aircraft was not totally in serial production – it was being produced but not completely delivered – so some of the cost had to be based on estimates. We are now better equipped on both sides to understand how to maintain the platform. We have a better understanding of what is requested of industry and so we are working with

---

30 Australian National Audit Office, Audit Report No. 36 2005-2006 *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, p 32.

31 Australian National Audit Office, Audit Report No. 36 2005-2006 *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, pp 43-44.

DMO to find a better vision of and a better approach to the TLS cost of the platform.<sup>32</sup>

- 4.32 However, it is clear from the evidence that problems with the TLS contract did not arise solely as a result of poor estimates. As Mr Brendan Roberts of Australian Aerospace states:

In the case of the through-life support requested increase, about 30 to 40 per cent of that is associated with scope creep, we have heard – in other words, doing extra work; therefore more money. The remainder is our own fault, because we made poor estimates back then, five years ago.<sup>33</sup>

- 4.33 This was reaffirmed by Dr Gumley:

I gave evidence last time that, when we specified the extent of work in the through-life contract, we did not get it all right. In fact, we actually expanded the scope of work. So part of what the company is asking for is what we have asked for – we have actually asked them to do more work.<sup>34</sup>

- 4.34 The Committee is somewhat satisfied that the Kinnaird reforms have, and will continue to have, a positive impact on lessening the extent to which scope creep can now occur (see Chapter 3 for a discussion around this issue). However, problems with the ARH Project Air 87 tender process, specifically the TLS portion of that process, appear to have cast a shadow on the perceived integrity of tender processes across Defence as a whole. For example, Mr Joe Moharich, openly declaring himself to be a 'disgruntled losing bidder'<sup>35</sup>, said:

In announcing that Eurocopter was the successful tenderer for Air 87, the then Minister for Defence, Mr Peter Reith, said that a major factor in Eurocopter's favour was their Australian Industry Involvement (AII) undertaking to set up a commercial helicopter production line for the EC 120, in Brisbane; between 30 and 50 helicopters per year were to be manufactured.

That undertaking appears not to have been incorporated in the Air 87 acquisition contract, notwithstanding it was a major requirement in the RFT.<sup>36</sup>

---

32 Mr Joseph Saporito, transcript, 19 October 2007, p 6.

33 Mr Brendan Roberts, transcript, 19 October 2007, p 26.

34 Dr Stephen Gumley, transcript, 1 March 2007, p 15.

35 Mr Joe Moharich, sub 6, p 1.

36 Mr Joe Moharich, sub 6, p 2.

- 4.35 Mr Moharich appears to attribute this type of experience to a general cultural deficiency across Defence in terms of their acquisition processes:

The total lack of transparency in the acquisition processes [is] the key issue. It is a widely held belief that when the DMO negotiates with a "Preferred Tenderer" the final, "negotiated" contract bears very little resemblance to what was specified in the "Request for Tender". The DMO steadfastly refuses to divulge the contents of a contract, citing "Commercial Confidentiality". Debriefs to losing bidders are invariably meaningless, with the DMO stating only that the contract was awarded on the basis of DMO's assessment that the chosen contractor offered the "Best Value for Money". Specifics are not given. Contracts such as the Project Air 87 ARH acquisition (previously described by the DMO's Chief Executive as a model of good contracting, was until recently claimed by DMO to be "on cost/on time") will not deliver equipment at anything approaching the (mandatory) delivery date specified in the RFT, and the value of the contract far exceeds what was announced by the then Minister for Defence.<sup>37</sup>

- 4.36 According to Mr Moharich, this lack of transparency in the tender process has resulted at least in the following impact:

The situation is now such that a very large potential supplier, a US based aircraft manufacturer, has made it known that it is most unlikely they will again respond to an Australian DMO RFT; the manufacturer has lost all confidence in the integrity of the DMO's acquisition process.<sup>38</sup>

- 4.37 Whilst recognising there are significant difficulties associated with project management, the Committee is satisfied that poor project/contract management practices are not universal across the DMO. As the Auditor-General states:

You might recall that we did an audit report a few years ago now of various SPOs, and the performance in some was very good and the performance in the others was at the other end of the spectrum.<sup>39</sup>

---

37 Mr Joe Moharich, sub 6, p 2.

38 Mr Joe Moharich, sub 6, pp 2-3

39 Mr Ian McPhee, transcript, 17 August 2006, p 14.

- 4.38 The Committee also heard and accepts that Defence should not bear sole responsibility for less than satisfactory acquisition outcomes. As the Auditor-General states, industry must share some responsibility in this respect:

While our audits always focus on what Defence or DMO are doing...the Audit Office and everyone else need to recognise that DMO partner with industry and not all of the problems are theirs alone.<sup>40</sup>

- 4.39 Indeed, as can be seen from the following quotes, industry have taken steps to improve their own performance culture in this regard:

Problems in the acquisition of defence capital equipment have not been the responsibility of the DMO (or its antecedents) alone. Industry has to shoulder a significant portion of the blame and Raytheon Australia believes that this has been recognised with most companies undertaking their own programs to improve performance through skills, processes, tools and culture change.<sup>41</sup>

Since the ANAO report of May 2005, ADI has made considerable efforts to overcome these challenges. ADI has learnt from experience and implemented several key changes to improve its performance...<sup>42</sup>

- 4.40 Taken together, the Committee is satisfied from the evidence that Defence is taking steps to tighten its contract management practices. For example, the Committee heard that Defence has placed an increased emphasis on ensuring that contracts contain greater numbers of payments being linked to milestones, or contracts containing a mix of milestones and EVMs, rather than largely on EVMs alone. As Dr Gumley states:

...Earned value management is not a bad system but if it is used in isolation quite often the milestones do not get met...We are finding out that the better system is a combination of earned value management and milestones. If they do not meet the milestones the earned value payments stop...A number of our difficult contracts from the 1990s were structured around the older techniques and now we are

---

40 Mr Ian McPhee, Standing Committee on Finance and Public Administration, Estimates, transcript, 22 May 2007, p 125.

41 Raytheon Australia Pty Limited, sub 5, p 6.

42 Mr Baghaei, transcript, 12 October 2006, p 5.

looking to get a better commercial balance moving forward in the new contracts.<sup>43</sup>

- 4.41 Additionally, in 2006, Mr Cronin stated that he expected improvements to the early phases of the capability life cycle as a result of the implementation of the Kinnaird recommendations:

As a more commercial focus comes through, as Kinnaird comes more into play and once we move out of the transitional phase, I think there will be an improvement, because they will have that understanding of the deal. Both sides will understand the deal.<sup>44</sup>

#### Committee comment

- 4.42 It remains unclear to the Committee what improvements have been made in project management practices across the DMO. The Committee will therefore carefully monitor improvements in project management practices through its routine reviews of ANAO performance audits.

### Indiscipline – inventory management

- 4.43 The Committee heard a great deal of evidence which appears to suggest that there is a culture of indiscipline around inventory management practices. Reference was often made to issues that have long been recognised with Defence's Standard Defence Supply System (SDSS), Defence's inventory management system.<sup>45</sup>
- 4.44 Dr Mark Thomson, a Defence observer, notes that the importance of an effective and fully functioning logistics management system such as SDSS cannot be overestimated:

The Department of Defence needs to be ready to fight wars, and to do so it needs to know what assets it has on hand and what condition they are in.<sup>46</sup>

- 4.45 The Committee is aware that many of the issues related to inventory management impact significantly on financial management

---

43 Dr Stephen Gumley, transcript, 11 May 2006, p 16.

44 Mr Colin Cronin, transcript, 17 August 2006, p 9.

45 See Australian National Audit Office, Audit Report No. 5 2004-2005, *Management of the Standard Defence Supply System Upgrade* and Australian National Audit Office, Audit Report No. 10 2006-07, *Management of the Standard Defence Supply System Remediation Programme* for full details regarding SDSS.

46 Dr Mark Thomson, transcript, 8 February 2007, p 2.

(see Chapter 2) and that these issues form the focus of Defence's financial remediation plans. However, the Committee remains concerned about general practices associated with the recording and storing of inventory.

- 4.46 Mr Ian Matthews, a former Defence employee, is a vocal critic of Defence's capacity to maintain accurate stock levels. In his written submission and oral evidence, Mr Matthews makes a number of assertions about questionable practices he claims to have witnessed during his period of employment with Defence. These include, for example, expensing newly purchased items rather than listing these items as assets which has a significant impact on Defence's capacity to report the level of their assets accurately:

Defence does not even know the value of spares and other inventory it holds in its warehouses at any point in time. If they do not know the value they are holding, how can they financially manage this asset? By not knowing the value of items, I am not referring to having incorrect records as to what is on hand. What I am referring to is them simply expensing the item when it is purchased into the warehouse and therefore not recognising it as an asset. Such expensing of items in warehouses, rather than when they are issued to users, solely relates to Defence's wish to minimise the amount of assets they have to record in their accounts and other records. This activity has little logic attached to it. They will record a \$2 sparkplug related to a motor sitting in the warehouse, but a motor sitting in the same warehouse related to that sparkplug will not be recorded if its value is less than \$10,000.<sup>47</sup>

- 4.47 Mr Matthews also described the following incident, illustrating the paucity of Defence's stock records:

I was at Moorebank one day when they were receiving goods. There were trolleys with about six or seven wooden boxes on them and they were just about to put them away. I said, 'How do you check what you have been billed for is in those boxes?' and they said, 'We don't.' I said, 'Why not?' Their logical answer was, 'We wouldn't know whether what is on that description is in that box, even if we could see it.' That is what happens with stocktaking as well. The item number is

---

47 Mr Ian Matthews, sub 1, p 4.



written on the box and the box is put up on the shelf. It is never opened. When they do a stocktake, all they ever do is check there is a box there.

...

In regards to Coles Myer, people know it is a packet of Cornflakes, it is a dress or whatever. In Defence they do not know that...<sup>48</sup>

- 4.48 The Committee notes that the Department of Defence has responded to many of the claims made in Mr Matthews' submission. For example, with regard to the claim about expensing items of inventory rather than recording them as assets, Defence indicated:

Inventory items received into warehouses are not expensed but recognised as assets.<sup>49</sup>

- 4.49 However, issues relating to the capacity for personnel to identify and therefore appropriately and accurately take stock of items (as alluded to in Mr Matthews' quote above) reaffirmed in the minds of Committee members that more needs to be done to ensure that stock records are accurate. Following a site visit to the Defence National Storage and Distribution Centre, Moorebank as part of a JCPAA Audit hearing on 27 June 2005, the Committee expressed concern at the degree to which personnel employed at that centre are able to identify, in particular, highly technical pieces of equipment.
- 4.50 To explore whether these types of issues existed and how they were dealt with in large commercial organisations, the Committee visited the Qantas Distribution Centre at Mascot in Sydney on 2 April 2007.
- 4.51 The Committee was informed that Qantas' inventory control system has approximately 500,000 line items and of these approximately 250,000 are in stock at any time. While recognising that Defence National Storage and Distribution Centre, Moorebank holds a significantly greater number of items than the Qantas Distribution Centre at Mascot, the Committee was impressed not only by the fact that Qantas is able to identify stock levels and value at any given time, but also by the manner in which items stored in the Centre are accounted for. For example, when parts are received into the Centre, receipt inspection is undertaken at different levels depending upon the nature of the item. The first, elementary level involves items such

---

48 Mr Ian Matthews, transcript, 8 February 2007, p 40.

49 Department of Defence, sub 4.3, Attachment A.

as basic stores and consumables (e.g., lubricants, rags) and a minimal level of personnel training is required to inspect these items. The second, mid-level inspection involves items such as parts (e.g., aircraft tyres) and processes whereby part numbers are matched with invoices and the condition of the item is checked. These inspections are undertaken by trained product examiners. At the third and highest level, items are inspected by a Receipts Compliance Inspector. Such an inspector is required to hold aircraft trade qualifications. Here individually serially numbered items are checked against paperwork, (e.g., an overhauled jet engine assembled from many individual components all of which must be receipted appropriately).

#### Committee comment

- 4.52 The Committee believes that in order to maintain stock records accurately it is important that personnel are able to definitively identify and thereby determine the status of stock held within its stores area. The Committee notes that as part of its remediation plans, in particular remediation plan S1 which addresses Stores Record Accuracy, that Defence reported the implementation of new stocktaking practices and procedures in 2005-06. Again, the Committee welcomes the recent comments of the current Secretary of the Department of Defence, Mr Nick Warner, expressing his intention to modernise the warehouse management system.<sup>50</sup>

#### Reticence to recover damages

- 4.53 One option available to the Government to mitigate risk is to seek remedies through the enforcement of contract provisions such as liquidated damages.
- 4.54 According to Defence's submission no 4.1, when an event occurs that requires liquidated damages, damages in the form agreed between the parties become due. The form these damages take may be cash, compensatory work/supplies, or a combination of both.<sup>51</sup>
- 4.55 However, the Committee notes (as per the ANAO's summary analysis set out above) that in the case of the FFG Upgrade, while the contract contains liquidated damages provisions, a May 2006 Deed

---

50 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008.

51 Department of Defence, sub 4.1, response to Question W12.

released both parties from liquidated damages prior to that date and as at September 2007, no liquidated damages had been claimed.

- 4.56 Additionally, as the total amount of liquidated damages is capped at \$2.5 million per FFG, \$0.75 million for the Operator Trainer and Weapon System Support Centre, and \$10 million overall, this does not serve to deter contractors from schedule blow-outs:

The value of liquidated damages represent less than one per cent of the contract price, and so it is unlikely to effectively discourage late deliveries.<sup>52</sup>

- 4.57 The ANAO claims that the ultimate effect of this is as follows:

The DMO is not well placed to exert influence over the Prime Contractor performance at this time due to the nature of the original contract, and the extent of funds already advanced.<sup>53</sup>

- 4.58 With regard to ARH Project Air 87, Major General Tony Fraser indicated to the Committee at the hearing on 1 March 2007 that:

...the readiness for training has a liquidated damages bill of \$10.2 million attached to it, which the company acknowledges it will need to pay. We will execute that once we gain delivery of the Tiger flight simulator.<sup>54</sup>

- 4.59 The Committee note that the simulator was accepted in December 2007 and upon enquiries into the execution of the liquidated damages, the Committee was advised the following:

As part of the dispute resolution on all ARH matters, that included the issue of Liquidated Damages, DMO has negotiated the provision of two EC135 helicopters to be based in Darwin for two years so as to provide lead-in skills training to the ADF.<sup>55</sup>

- 4.60 While the Committee accepts liquidated damages can take any form agreed by the parties (e.g., cash, compensatory work or supplies), these examples reflect something broader. Specifically, that there is a culture of reticence across Defence around the enforcement of contracts, particularly in terms of cash compensation. As someone

---

52 Australian National Audit Office, Audit Report No. 11 2007-08 *Management of the FFG Capability Upgrade*, p 56.

53 Australian National Audit Office, Audit Report No. 11 2007-08 *Management of the FFG Capability Upgrade*, p 19.

54 Major General Tony Fraser, transcript, 1 March 2007, p 3.

55 Department of Defence, sub 4.7.

with an industry background, Mr Moharich expressed that view as follows:

...the DMO has a well-known policy of not enforcing contracts. Contracts seem to be treated as statements of intent rather than as legally binding documents.<sup>56</sup>

- 4.61 Further, according to Mr Moharich, one of the impacts of not enforcing contracts is the encouragement of low bidding (a claim relevant to the TLS contract on ARH Project Air 87 referred to above):

By not enforcing contracts that are entered into, DMO really invites the practice of low bidding. There is a practice – and it is well known – of bidding whatever you think will get you to the negotiating table and then negotiating something a lot more favourable. When the contract is three or four years down the track and you know that it cannot be cancelled – the Commonwealth could not afford the cancellation or the delay – you start ratcheting up and making more demands. My suggestion is that if there is a contract, why does Defence not enforce it? Send a signal to the contractor that says, ‘That was what you promised.’<sup>57</sup>

- 4.62 This latter point of view was shared by Dr Mark Thomson:

Having understood the situation with the Tiger helicopters, perhaps the problem is not so much one of evaluating the tenders but one of locking in a contract with the tenderer at what they bid for initially and holding them to it. It seems to me that that second step could have been a remedy for the circumstance.<sup>58</sup>

- 4.63 The issue of Defence not enforcing contract provisions was raised during the Senate Foreign Affairs, Defence and Trade References Committee inquiry in 2003. At that time, Defence openly outlined its preference for negotiation over litigation.<sup>59</sup> This preference was reasserted by Dr Gumley during this Committee’s inquiry as follows:

I would prefer not to go to litigation; courts are very uncertain vehicles. You can spend a heck of a lot of money on lawyers and get an outcome you do not always expect. In

---

56 Mr Joe Moharich, transcript, 28 March 2007, p 3.

57 Mr Joe Moharich, transcript, 28 March 2007, p 3.

58 Dr Mark Thomson, transcript, 8 February 2007, p 9.

59 Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p 74.

nearly all occasions you get the evidence, you get the data, you present the data and mature and experienced project managers sit down, work out where the evidence lies and reach an arrangement with money transfers one way or the other, depending on what the data says.<sup>60</sup>

- 4.64 The Committee is aware of the difficulties around this issue, particularly in circumstances where Defence is required to maintain relationships in the context of a sole source environment with access to only one contractor who can fulfil Defence requirements. As Dr Gumley states:

A contract is between two parties and you ask yourself the questions: who else could do the work and who else is interested in doing the work? We are getting a lot of pressure from companies to not have any liquidated damages in contracts. Companies, for their natural interest, want softer contracting; the tone of the questioning here is we should have tougher contracting. It becomes almost a social contract between Defence and industry as to what is the appropriate balance. If we come up with totally draconian contract terms, I will have nobody to contract with.<sup>61</sup>

- 4.65 Dr Gumley further outlined the difficulties around quantifying damages such as those associated with a loss of capability:

Clearly, you cannot put a value on the ability to fire a missile off a ship at somebody when you do not know if there is going to be an event that requires you to fire a missile...we are a 'just-in-case' organisation; we are not a profit making organisation. So for the courts, if you ever got into a dispute with a contractor about what is the opportunity cost of not being able to fire a missile, I think a lot of people would have a difficulty putting a quantum on that.<sup>62</sup>

- 4.66 When questioned about whether Defence should include opportunity costs in their contracts, Dr Thomson also drew out the complexities involved in this issue:

There are liability clauses in some contracts and they tend to be relatively modest, in my experience. I do not know whether you would get better outcomes if you put punitive

---

60 Dr Stephen Gumley, transcript, 7 December 2006, p 16.

61 Dr Stephen Gumley, transcript, 7 December 2006, p 13.

62 Dr Stephen Gumley, transcript, 7 December 2006, p 22.

clauses into contracts, but I do know one thing: the contracts would cost more. If you wanted the provider to indemnify you against the project going pear-shaped...they will just pile the dollars on top of the contract. With the large portfolio of contracts that Defence has, that is probably not the prudent way to proceed.<sup>63</sup>

4.67 Reflecting an industry perspective, Mr Bradford of BAE Systems Australia also made the following point:

As a company, we do not object to signing a contract that says we will deliver these things and, if we end up spending \$50 million more than we are paid to deliver those things, we will do it because that is what we do. If, on the other hand, you want to put \$150 million of liquidated damages on a \$10 million contract, I am going to say I do not want to do that... I am, in principle, okay with LDs as long as they are executed within a framework that I can control –<sup>64</sup>

Committee comment

4.68 It is clear that issues related to the form of compensation the Government should receive as a result of poor performance on behalf of contractors are fraught with difficulties. And, although recent events such as the termination of payments on ARH Project Air 87 may reflect a positive shift in the culture of non-enforcement described above, the Committee remains concerned about what appears to be a reticence to claim appropriate damages, particularly in circumstances where delays have led potentially to a diminished capability.

4.69 The Committee is hopeful that the effort expended on ensuring that the Kinnaird Review's focus on risk management is maintained, together with a meticulous application of Commonwealth policy to allocate risk to the party best placed to manage it (see section 4.89 below), may lead to a more appropriate balance of responsibilities between industry and the Commonwealth. The Committee expects this would lead to contract provisions being enforced in circumstances where the Commonwealth would otherwise suffer significant financial disadvantage.

---

63 Dr Mark Thomson, transcript, 8 February 2007, p 12.

64 Mr Harry Bradford, transcript, 8 February 2007, p 32.

- 4.70 The Committee will keep this matter under review as audits of post-Kinnaird projects are tabled in the future.

### **Military-off-the-shelf**

- 4.71 Confusion around the term military-off-the-shelf was a persistent theme during the inquiry in relation to the purchase of the Tigers.
- 4.72 In its Audit Report No. 36 of 2005-06, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, the ANAO outlines how throughout the development phase for this project Defence advocated the adoption of an ‘off-the-shelf’<sup>65</sup> acquisition strategy so as to:

...reduce the costs of integration and development, reduce technical and schedule risk, improve interoperability with overseas forces and reduce the overall cost of acquisition.<sup>66</sup>

- 4.73 One important implication of purchasing MOTS aircraft such as these is that Australia would not become the lead customer. The majority of the risk related to the developmental aspects of the project was to have been borne by military organisations elsewhere. As the ANAO states:

It was intended that the Australian Tiger ARH Project would follow the French and German programs, which the DMO advise were, at the time of making the choice to procure Tiger aircraft, 18 months in advance of the Australian program.<sup>67</sup>

- 4.74 Yet, the Committee heard contradictory and sometimes confusing evidence about whether indeed the Tigers were ever intended to be an off-the-shelf purchase and whether they should now be considered as having been a MOTS purchase, in light of the stage of their development relative to the same aircraft in other international military organisations.
- 4.75 In Audit Report No. 36, the ANAO suggests that ARH Project Air 87 was more developmental in nature than originally thought:

The procurement of the Tiger ARH represents the purchase of an aircraft, which was more developmental than anticipated,

---

65 See Section 4.15 above for Department of Defence definition of off-the-shelf.

66 Australian National Audit Office, Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, p 38.

67 Australian National Audit Office, Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, pp 11-12.

where 14 of the 900 core requirements of the selected aircraft type required modification.<sup>68</sup>

- 4.76 Evidence for this view was also provided at a hearing on 17 August 2006 by Mr Colin Cronin from the ANAO, who argued that Australia is indeed the lead customer (and, by implication the Tigers were not an MOTS purchase):

...we are the lead acquirer of the Tiger. Obviously, the ADF had to put a lot more effort into test and evaluation. The French equivalent did a lot of the work, but essentially Australia had transitioned to the lead acquirer of the Tiger when it was initially envisaged as an off-the-shelf purchase.<sup>69</sup>

- 4.77 However, Mr Joseph Saporito, CEO of Australian Aerospace, the contractors involved in the Tigers acquisition still considers the Tigers were as an off-the-shelf purchase. As he states:

...from an industry perspective, the ARH is an off-the-shelf aircraft because it is mainly based on an aircraft that [was] designed for the European program – the Franco-German program. The basic vehicle is exactly the same. We have just taken some equipment from the French aircraft and some equipment from the German aircraft to build an ARH. It is an off-the-shelf aircraft. There have been two major customisations. One was the integration of the hellfire system, which has been fully successful. It is a US missile and it is the first time a US missile has been integrated in a European platform. It was a challenge but we did it. It has been completely successful.<sup>70</sup>

- 4.78 When asked to further clarify whether the customisations outlined in the quote above were intended at the point where the contract was signed, Mr Saporito responded as follows:

Yes. At the commencement of the contract we knew that we had to integrate the hellfire missile and we knew that we had to customise a radio communication system, which is specific to it. It is always the case that we have to customise it. Every nation has a radio communication system.<sup>71</sup>

---

68 Australian National Audit Office, Audit Report No. 36, *Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87*, p 39.

69 Mr Colin Cronin, transcript, 17 August 2006, p 9.

70 Mr Joseph Saporito, transcript, 19 October 2007, p 5.

71 Mr Joseph Saporito, transcript, 19 October 2007, p 5.



- 4.79 At the hearing on 1 March 2007, Brigadier Andrew Dudgeon, Director General, Army Aviation Systems, DMO clearly maintained that Australia is not in fact the lead customer in relation to this aircraft:

France and Germany are well and truly still the lead customers of the Tiger. One of the major risk-mitigating factors early on was that we would leverage off this certification basis of the French product, the HAP Tiger, and we still do that. The French and the Germans are the ones carrying a great deal of the risk in developing the product.<sup>72</sup>

- 4.80 More recently, at a hearing before the Defence Subcommittee of the Joint Standing Committee on Foreign Affairs, Defence and Trade, Dr Gumley clarified the position as he now saw it:

We have pretty much found ourselves as the lead customer with regard to the Tiger, although we did not start as the lead customer.<sup>73</sup>

- 4.81 On 19 October 2006, in response to a Committee question about whether Defence was in error identifying this project originally as an off the shelf product, Mr Cronin of the ANAO replied, "yes".<sup>74</sup>

- 4.82 The Committee is concerned about what appear to be ambiguous, or at the very least inconsistent, approaches to 'off-the-shelf' and 'lead customer'. This concern was reinforced with the following evidence from Mr Saporito, Australian Aerospace:

...the definition of off the shelf will be different in the specific Defence document to that which we consider in industry.<sup>75</sup>

- 4.83 This concern is compounded by the Committee's knowledge that the purchase of MOTS items is the current preference of the ADF as outlined by Air Chief Marshal Angus Houston before the Senate Standing Committee on Foreign Affairs, Defence and Trade on 20 February 2008:

I want to go on the record as saying that most of our issues are with legacy projects that came from a different way of doing business in the past and perhaps a way of turning requirements into equipment that did not always work very well, because we were probably overly ambitious and did not

---

72 Brigadier Andrew Dudgeon, transcript, 1 March 2007, p 4.

73 Dr Stephen Gumley, transcript, 10 July 2008, p 40.

74 Mr Colin Cronin, transcript, 19 October 2006, p 8.

75 Mr Joseph Saporito, transcript, 19 October 2006, p 10.

resort to the military or civilian off-the-shelf approach which we much prefer in the modern era.<sup>76</sup>

- 4.84 Having said that, the Committee is also mindful of the complexities that may be involved in adhering to a definition of MOTS as pointed out in evidence provided by Mr Brendan Roberts, Board Director, Australian Aerospace:

This also points out the tension here between a line in a publication perhaps which people have to follow in their jobs when the government department says, 'You shall buy military off-the-shelf,' and what that means. For example, a few months ago we bought military off-the-shelf in this country; four beautiful C17 aircraft. They were absolutely military off-the-shelf. You go down to the garage and you buy them, and you get exactly what they offer – no changes at all, whether you wanted them or not. That is military off-the-shelf. In the end, the test is whether this is good for the ADF and especially the people operating these aircraft.

Now we have a situation with the Air 87 program where our aircraft was reaching the end of its development program – fully documented, by the way, in France and Germany, with First World oversight. Do we disqualify this aircraft from consideration because it is not, strictly speaking, military off-the-shelf? That is, you cannot go down to the garage tomorrow and buy it, but within two or three years you will have the world's best armed reconnaissance helicopter capability and you will have it for the next 30 or 40 years. Do you turn your back on that and instead pick up something which is already in service, possibly 10 or even 20 years, because you had very little to choose from?<sup>77</sup>

#### Committee comment

- 4.85 In light of this confusion, and the Department's preference for purchasing military/civilian off-the-shelf as articulated by Air Chief Marshal Angus Houston on 20 February 2008, the Committee is keen for Defence to clarify further the meaning of 'off-the-shelf' and 'lead customer'.

---

76 Air Chief Marshal Angus Houston, Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, p 45.

77 Mr Brendan Roberts, transcript, 19 October 2006, p 25.

- 4.86 To that end, the Committee again welcomes the Defence Procurement and Sustainment Review noting its intention to examine:

The potential advantages and disadvantages of the greater utilisation of Military Off The Shelf (MOTS) and Commercial Off the Shelf (COTS) purchases.<sup>78</sup>

- 4.87 The Committee also notes that one of the major frustrations for Members of Parliament and others performing an oversight role of Defence acquisition, is the variable meanings applied to Defence terminology. This includes the use of terms such as 'legacy projects', and 'cost blow outs' which lead to perceptions of shifting baselines which impact significantly on one's capacity to assess the status and progress of projects. Standardising terms such as these will be of most consequence to the anticipated review of Defence's Major Projects Report. This issue is addressed further in Chapter 5.

## Risk allocation

- 4.88 The question of mitigating the extent to which the Government, and ultimately the taxpayer, is exposed to financial risk is a critical and complex issue and one that was frequently raised over the course of the inquiry.
- 4.89 The Committee heard that DMO policy on the allocation of risk is as follows:

In DMO contracts, consistent with Commonwealth policy, risks should be borne by the party best placed to manage them (Commonwealth Procurement Guidelines, paragraph 6.10). This may be the Commonwealth, the Contractor, or both.

The level of risk accepted by DMO will vary from contract to contract, depending on the nature of the particular procurement. Factors such as the amount of developmental work, Information Technology integration, and customisation will affect the risk profile, from the perspective of both the DMO and the contractor. Where more risk is accepted by the DMO, a lower price will normally be negotiated, noting also the level of competition in the relevant market. In some cases, the acceptance of high levels of risk by DMO in order to

---

78 The Hon Greg Combet MP, *Defence Procurement and Sustainment Review*, media release, 7 May 2008.

deliver capability requirements is unavoidable. DMO considers that a successful project is one that delivers a fit-for-purpose capability, as approved by Government, within the approved budget and schedule.<sup>79</sup>

4.90 Evidence provided to the Committee tended to focus on two key areas of risk: *technical risk* (e.g., is the technology realisable<sup>80</sup>) which is particularly pertinent in the early stages of the capability life cycle such as concept development; and *commercial risk* (e.g., what is the appropriate type of contract, who will manage knowledge gained from project etc.) which is pertinent to the acquisition phase of capability acquisition.

4.91 Across both those areas of risk, the Committee heard the necessity for, and complexities around, risk management involved in the acquisition of equipment. For example, as Dr Gumley states:

If DMO is to provide leading edge capabilities through our war fighters and peacekeepers, we must have a healthy risk appetite. If we did not, the risk would simply transfer to the ADF in operations.<sup>81</sup>

4.92 At the hearing on 7 December 2006, Dr Gumley added the following:

It is absolutely true that the defence procurement is probably the riskiest business activity in this country. Anyone who thinks we are going to go about procurement and take no risks is just kidding themselves. What we have to do in defence procurement is recognise that it is impossible to transfer all the risk. It is impossible to evade it. Similarly, we should, through our contracting formulas, not attempt to take on excessive risk. There is an optimum amount of risk and then you manage it intensively. That is why you have a DMO with 7,000 people, with over 1,000 engineers and 500 project managers; our prime job is to manage risk.<sup>82</sup>

---

79 Department of Defence, sub 4.1, response to Question W12.

80 Dr Roger Lough, transcript, 23 May 2007, p 9.

81 Dr Stephen Gumley, transcript, 11 May 2006, p 7.

82 Dr Stephen Gumley, transcript, 7 December 2006, pp 18-19.

- 4.93 Mr McPhee, the Auditor-General, also reiterated the inevitability for risk in Defence acquisition:

At the end of the day, as most people in Defence will tell you, some of these risks you can seek to mitigate but you probably cannot eliminate.<sup>83</sup>

- 4.94 One of the primary intentions of the Kinnaird Review was to address the issue of risk:

[A strong mandatory two-pass system] should be characterised by a higher proportion of project funds being spent on early analysis to provide better and more relevant information to government and to ensure that projects are less likely to develop problems during the acquisition phase. This would include rigorous analysis of technology, and cost and schedule risks, including external scrutiny and verification.<sup>84</sup>

- 4.95 The Committee notes Dr Gumley's evidence before the Defence Subcommittee of the Joint Standing Committee on Foreign Affairs, Defence and Trade about the new steps being taken to mitigate risk through the gate review process:

...We will have a series of gates. It is very similar to the process that the large industry organisations do with their major projects. So it will be at a stage of pre-first pass, pre-second pass, at pre-contract signature, to make sure we understand it exactly, and even after we have gone to government at second pass, we have gone through the National Security Committee of cabinet and we have got government agreement, post that there is a period of negotiations that occur with a contractor. So before we sign up to a contract we have an executive review, and for those larger programs...that will be conducted by me, the CEO and the general manager of programs – all experienced program managers who have managed multibillion-dollar programs in the past. So there is a process.<sup>85</sup>

- 4.96 As outlined in the previous chapter, the Committee welcomes the Defence Procurement and Sustainment Review's intention to improve the Department's handling of technical risk particularly in relation to
- 

83 Mr Ian McPhee, transcript, 17 August 2006, p 12.

84 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p v.

85 Dr Stephen Gumley, transcript, 10 July 2008, p 11.

developmental acquisition projects. The Committee notes the importance of the initial allocation of risk between Government and industry at the contracting stage of the acquisition process.

4.97 As Dr Gumley points out:

There are some areas of risk which the Commonwealth should always retain, there are other areas of risk which clearly belong to the companies and there is a portion in between which can be debated from project to project.<sup>86</sup>

4.98 However, the Committee also notes the following comment by Dr Gumley:

It would be a more efficient allocation of Commonwealth moneys for the companies to take on more risk in some areas because they can look after them. There is an imbalance, for example, at the moment between the ability of the Commonwealth to levy liquidated damages in a contract versus the company's ability, if we do something wrong, to ask us to pay expensive excusable delay claims. It is a complicated area of contracting.<sup>87</sup>

4.99 The balance between Defence and industry in this allocation was also articulated by Mr Fisher from Raytheon Australia Pty Limited as follows:

There is a balance and it is up to industry to decide whether it is going to take the risk on or not. In the letter from Dr Gumley on 14 March he says that he believes in fixed-price contracts and he believes that industry should profit and that the profit should be commensurate with the risks you take because you could lose the profit. So there is a balance. But we need to be very careful when we look at this and say, 'We really need to modify this and enhance that,' because strategically we want to do this. In the region we need to be that step ahead. If we can buy something off the shelf and do something clever with it to give us the extra edge then we should do that. That is recognised, and the government has also recognised that industries taking on that risk can get a higher profit, whatever that number is – whatever the market will bear.<sup>88</sup>

---

86 Dr Stephen Gumley, transcript, 9 May 2007, p 3.

87 Dr Stephen Gumley, transcript, 9 May 2007, p 3.

88 Mr Ronald Fisher, transcript, 28 March 2007, p 19.

### Committee comment

4.100 The Committee notes the complexities inherent around the allocation of risk in major acquisition projects. Given the critical importance of appropriate, logical and transparent risk allocation to the proper management of major Defence acquisition projects the Committee welcomes the fact that issues around risk allocation are a high priority and currently being addressed by DMO:

We are working with industry to try to make it happen. Just last week I had all the chief executives of the main prime companies discussing with my senior people and me how we are going to do this better. At this stage it is a cooperative process and I am quite happy with the way it is going.<sup>89</sup>

### Personnel – recruitment, training and retention

4.101 The importance of appropriately trained staff in the context of the Defence acquisition process was identified in the Senate Foreign Affairs, Defence and Trade References Committee 2003 report *Material acquisition and management in Defence*. More specifically, that Committee recommended:

...that special training and professional development be undertaken jointly by capability and acquisition staff to ensure that all staff have a clear understanding of, an unequivocal commitment to, and the skills and knowledge to fully implement the practices specified in the *Capability Systems Life Cycle Management Manual 2002*.<sup>90</sup>

4.102 That Committee also expressed concern that the people reforms being undertaken by the DMO at that time would prove difficult to implement given the skill shortages in project management, contracting and software development.

4.103 As can be seen from the following quotes, difficulties with appropriately-trained staff was an issue repeatedly referred to by Defence during this inquiry. For example, a dearth of suitably trained people was referred to in Exhibit 1, *Lessons Learned - FFG Upgrade Project* as follows:

---

89 Dr Stephen Gumley, transcript, 9 May 2007, p 3.

90 Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p 28.

Lack of expertise often leads to insufficiently scoped projects, problems during negotiation and hiccups during project execution. Suitably qualified personnel need to be engaged from the outset, and continuity of these skills knowledge and experience retained for the life of the project to ensure that every stage of the project is conducted skilfully and problems are minimised.<sup>91</sup>

If you go back to when that FFG project was put together in 1997 or 1998, you could probably argue that there were not enough good people on the project. This is one of our big challenges.<sup>92</sup>

- 4.104 Similarly, with regard to ARH Project Air 87, Defence also referred to staffing issues as the main lesson learnt during this acquisition:

The importance of staffing the project with appropriately qualified personnel; especially in the critical engineering, logistics and training disciplines. This is particularly relevant where the schedule set by Defence is aggressive.<sup>93</sup>

- 4.105 In response to questioning about whether the DMO has staff who are adequately skilled to negotiate on an equal footing with senior industry representatives, Mr Peter Nicholson from BAE Systems Australia also made reference to variability in skill levels:

...in some areas the maturity is very good and in some areas it is not.<sup>94</sup>

- 4.106 Defence has embarked on an extensive financial management and systems training program, and invested considerable funds and effort in developing the capacity of its staff in this regard (see also Chapter 2).
- 4.107 The Committee also heard that a comprehensive training regime to professionalise the DMO workforce was a prime focus of the senior leadership at Defence. Dr Gumley advised the Committee at the first hearing, on 11 May 2006, that 315 staff members had been certified as project managers to date with a further 207 enrolled and moving

---

91 Department of Defence, *FFG Upgrade – Lessons Learned*, exhibit 1, p 1.

92 Dr Stephen Gumley, transcript, 9 May 2007, p 20.

93 Department of Defence, sub 4.1, response to Question W1.

94 Mr Peter Nicholson, transcript, 8 February 2007, p 23.



towards certification. Two years prior, DMO had only 10 project managers with those levels of certification.<sup>95</sup>

- 4.108 At a more recent hearing before the Defence Subcommittee of the Joint Standing Committee on Foreign Affairs, Defence and Trade Dr Gumley indicated that DMO had now graduated 400 qualified program managers in courses and in practical work over the last four years.<sup>96</sup> At that hearing, Dr Gumley again stressed the importance of having experienced professional staff to manage risk properly for the Commonwealth:

The only way we are going to be able to reduce the Commonwealth's risks on these big projects is by having really good people inside the DMO.<sup>97</sup>

- 4.109 The Committee notes that the efforts of the Department in training, upskilling and professionalising its staff has been acknowledged both externally and internally. Such acknowledgements are illustrated in the following quotes by the Auditor-General and Mr Malcolm Kinnaird:

There are plenty of people, including auditors, who can tell you what the framework should be and how to progress management issues; but it is in the execution, and that goes to training and culture...Defence are investing probably more than they ever have before in training and people development issues, which I think is absolutely essential.<sup>98</sup>

It is my observation that the team have embarked on a project management training program that has been very successful in terms of the number of people who have been taken through project management disciplines and understanding and now have a qualification that they did not have before.<sup>99</sup>

- 4.110 However, while improvements in training and upskilling are widespread across Defence, the Committee is concerned with the evidence that suggests that Defence, like other agencies, is still experiencing real difficulties in its ability to attract specialised staff into the organisation. As the following quotes from Defence

---

95 Dr Stephen Gumley, transcript, 11 May 2006, p 7.

96 Dr Stephen Gumley, transcript, 10 July 2008, p 12.

97 Dr Stephen Gumley, transcript, 10 July 2008, p 13.

98 Mr Ian McPhee, transcript, 17 August 2006, p 22.

99 Mr Malcolm Kinnaird, transcript, 15 August 2007, p 6.

representatives suggest, this shortage relates to the need for both financial and acquisition staff:

This is one of our big challenges. A very substantial re-equipment of the ADF is coming up and we have to find enough people who have the domain knowledge and the commercial experience to be able to run all these projects. It is a challenge.<sup>100</sup>

One of the main areas of the up-skilling program is to train our own. We have been out to the market; we have seen what is there. It is a limited pool of qualified people. The industry, obviously, want exactly the same people. There are 7,000 people in DMO, but there are 26,000 people in the industry, and they need the same sorts of people.<sup>101</sup>

We have some positions that we are still not able to fill, with the trained people and the kind of money we can offer.<sup>102</sup>

...there is also an incredible shortage of skilled accounting folk in the country generally. That is one of the challenges we face to our training program.<sup>103</sup>

4.111 The poaching of trained staff also emerged as a significant challenge for Defence personnel management:

Of course the obverse happens: we skill up our people and they achieve a bit and somebody poaches them, but that is a measure of success, I guess.<sup>104</sup>

4.112 The Committee queried the factors underlying these issues and heard conflicting evidence about the impact of remuneration on the recruitment and retention of staff. For example, in the following quote Mr Malcolm Kinnaird laments the salary restrictions the Department of Defence is subject to:

The tragedy is that they are being trained in an organisation that is not able to pay competitive salaries with the top private sector so inevitably there is going to be leakage out as they train, just as there used to be in the large public bureaucracies – and I fancy that that might accelerate. I do not

---

100 Dr Stephen Gumley, transcript, 9 May 2007, p 20.

101 Dr Stephen Gumley, transcript, 9 May 2007, p 20.

102 Mr Ric Smith, transcript, 11 May 2006, p 15.

103 Mr Phillip Prior, transcript, 11 May 2006, p 15.

104 Mr Ric Smith, transcript, 11 May 2006, p 15.

think that there are many private organisations that are investing so heavily in project management training and development.<sup>105</sup>

- 4.113 Yet, Mr Harry Bradford of BAE Systems Australia, suggests below that remuneration is not the issue:

...whenever I have confronted problems with retention, remuneration has rarely been the cause.<sup>106</sup>

- 4.114 Dr Mark Thomson suggests that one approach to alleviating the skills shortages currently being experienced by Defence would be to buy in the necessary expertise:

Defence either can train people or can buy them in from outside. Already DMO has an extensive program for professionalisation... That will get them only so far. At some point, for some big projects I think it is prudent to bring people in from outside and pay the money that is necessary – as they have done in a couple of cases. If you are going to run a multibillion dollar project, you should have someone in charge of it who can justify running a multibillion dollar project in the private sector. Defence have gone part of the way down that track. I think they should be pushing further down that track than they already have.<sup>107</sup>

- 4.115 The Committee agrees with this view. Until the DMO is staffed with appropriate numbers of personnel holding the requisite expertise and experience as a result of the extensive professionalisation program which is now taking place within the Department, the Committee believes additional resources will be required to attract and retain staff with high-level project management expertise.

- 4.116 In addition to broader issues related to Defence's capacity to attract staff, the Committee notes with some concern the level of 'churn' within the Department. Although Defence indicated to the Committee that the level of turnover for the FFG Upgrade Project was not considered high, and for ARH Project Air 87 it was lower than normal<sup>108</sup>, the Committee is concerned by the fact that the same personnel rarely hold responsibility for acquisition projects from start to finish. For example, on the FFG Upgrade Project, seven people

---

105 Mr Malcolm Kinnaird, transcript, 15 August 2007, p 6.

106 Mr Harry Bradford, transcript, 8 February 2007, p 30.

107 Dr Mark Thomson, transcript, 8 February 2007, p 9.

108 See Department of Defence, sub 4.1, response to Question W3.

occupied the role of Project Director position over a period of 14 years. Likewise, seven people had held responsibility for ARH Project Air 87 from October 2001 to January 2007, in some cases for periods as short as six months.<sup>109</sup>

4.117 The Committee accepts that it may be unrealistic to expect the same staff to retain the day-to-day responsibility over the life of the projects, particularly in circumstances where that lifespan is extensive. However, the Committee does expect that while personnel are moving in and out of those roles, much more emphasis should be placed on the retention and consolidation of relevant corporate knowledge.

4.118 This issue is one that was also recognised by Dr Gumley:

There is a problem with evasion of accountability, where people can move at level freely within the Public Service – change departments, change groups – and you lose the corporate knowledge. There is no ability, it seems, to direct people to stay in a position to get something finished. To my mind it is a very difficult problem. So what you have to do is try and set up systems to capture the knowledge that take that into account.<sup>110</sup>

4.119 The retention and consolidation of knowledge is all the more important in circumstances where, as the Committee heard, industry may be unlikely to share lessons they have learnt from acquisition projects. Mr Harley Tacey, Project Director from ADI Ltd states:

If you look at the complex programs that have been implemented over the last few years you will find that most of them have been implemented by a different company. One was Boeing, one was Rockwell, one was someone else, one was Saab et cetera. So the lessons may reside in those companies but those companies are competitors and are not necessarily going to share with their competitors all that they have learned from their lessons.<sup>111</sup>

---

109 See Department of Defence, sub 4.1, response to Question W3.

110 Dr Stephen Gumley, transcript, 15 August 2007, p 11.

111 Mr Harley Tacey, transcript, 12 October 2006, p 9.

- 4.120 Mr Meert from the ANAO, while reaffirming that ultimate responsibility for projects lies with the CEO, also highlights the importance of the appropriate maintenance of corporate knowledge related to projects:

I mean in the end the CEO is responsible. If you take over a major project, when you take it over you do have to get on top of that project and where it is at in terms of deliverables. I do not think you can wash your hands of the past forever. You do have to catch up with the project, know where the finances are and where the project deliveries are up to. So just because a project manager leaves does not mean it suddenly throws the whole project management regime out the door; they still expect the planes to come in because, for them, it is business.<sup>112</sup>

- 4.121 Drawing upon his experience with the UK Ministry of Defence, Mr Tim Banfield of the UK NAO made the point that documenting project successes and failure is important, not least because the lengthy nature of procurement processes:

Very often, as well, the reasons for failures and problems on projects are lost in the mists of time because the projects take so long that, by the time they are finished, it is difficult to distinguish.<sup>113</sup>

## Maintaining corporate knowledge – lessons learnt

- 4.122 As a result of this evidence, the Committee was keen to examine the degree to which Defence and the DMO were now focused on learning from past experiences, particularly in relation to the two acquisition case studies, the FFG Upgrade Project and ARH Project Air 87.
- 4.123 Defence indicated to the Committee on a number of occasions that learning the lessons gained from past acquisition projects was a priority for the Department. Dr Gumley indicated early on in the inquiry:

For this to be a valuable process for DMO to lead to improvement in procurement and acquisition, getting those

---

112 Mr John Meert, transcript, 13 June 2007, p 7.

113 Mr Tim Banfield, transcript, 20 June 2007, p 14.

systematic issues out on the table and learning from them is very important for us as well.<sup>114</sup>

- 4.124 In a later hearing, Dr Gumley also agreed with the Committee that more could be made of lessons learnt in procurement:

...there is more work to be done in capturing organisational knowledge. I agree. We still are perhaps over-stovepiped and that keeps the knowledge in.<sup>115</sup>

- 4.125 In response to questions taken on notice at the hearing on 7 December 2006, Defence provided the following information about how they were going about developing such a process:

A more formal approach to Lessons Learnt is being developed. It will involve the collection of information and data about projects at various points in the project life cycle. Information sources will vary such as Project Closure Reports, Project Audits, Project Governance meetings, or internal, independent Project Evaluation Reviews. The Lessons Learnt will be held centrally and made available to all staff. An appropriate means of doing this is yet to be defined. It is also anticipated that the Lessons Learnt could be incorporated into building project estimates.<sup>116</sup>

- 4.126 This approach was reaffirmed by Mr Kim Gillis, Deputy Chief Executive Officer, DMO, at the hearing on 1 March 2007 as follows:

One of the initiatives we are taking on in the project management world is that rather than just documenting it internally we are moving to publishing a lessons learnt document. For HMAS Sirius, one of our most recent projects, we are actually publishing – and we will be publishing this by the middle of this year – a lessons learnt document. This is going to be available in the National Library. We are going to be producing a number of copies to send to our equivalent organisations around the world. I want to move the organisation from just having internal lessons learnt documents because they do get lost. You write a document, you put it in a file and it gets archived. Sometimes, for example, in the case of an auxiliary oiler, we may only

---

114 Dr Stephen Gumley, transcript, 7 December 2006, p 2.

115 Dr Stephen Gumley, transcript, 15 August 2007, p 10.

116 Department of Defence, sub 4.1, response to Question W2.

purchase one of those every 20 years. So the best way to ensure that the message is never lost is to publish.<sup>117</sup>

- 4.127 In response to Committee questioning about whether information such as the appropriate modification of process and practice would be included in the lessons learnt document, Mr Gillis continued:

Again, it is a process whereby once you have done that you then also identify in the lessons learnt what activities you are going to undertake to remedy any of the problems you have. So it is a discipline that we would have to undertake. Once you publish something, you are far more accountable.<sup>118</sup>

- 4.128 The Department also indicated that case studies were becoming more prevalent in the DMO as a learning tool through leadership development programs and the DMO's Complex Project Management Competency Framework.<sup>119</sup>

- 4.129 Dr Gumley offered the following in relation to organisational changes he hoped would improve the capacity for information about lessons learnt to be shared more widely across the Department:

In a 'sustain it' world, a lot of it came from the three services which was Support Command and they got all put together into DMO in about 2000-01, and those cultures take a while to work through. Some of the organisational changes that were made recently, though, started to fix that, for example, Kim Gillis coming in as General Manager, Systems. I have used that title deliberately as he is going to handle five, shortly six, domain divisions. Each of those divisions is big in dollar-plus businesses. His job is primarily standardisation in how we do things right across air, sea, land, electronics, helicopters and the new one we are looking at is explosive ordnance and ammunition. So, organisationally, we are moving to exactly what you said.<sup>120</sup>

---

117 Mr Kim Gillis, transcript, 1 March 2007, pp 21-22.

118 Mr Kim Gillis, transcript, 1 March 2007, p 22.

119 Department of Defence, sub 4.1, response to Question W2.

120 Dr Stephen Gumley, transcript, 15 August 2007, p 10.

- 4.130 The notion of establishing a carefully documented lessons learnt process (including the successful elements of projects) was reaffirmed to the Committee when Mr Tim Banfield, of the UK NAO, relayed the following information about his experience with the Ministry of Defence in that country:

The Ministry of Defence has processes to learn lessons which are of variable quality and are used to a greater or lesser extent. An awful lot of it is what is in people's heads and passing on from time to time.

...One of the things that happens – maybe it is a UK trait; I do not know – is that we tend to dwell on the failures and accept successes as doing a day job. Actually, you can learn an awful lot from the successes. That bit does not happen...<sup>121</sup>

#### Committee comment

- 4.131 The Committee is satisfied that the extensive professionalisation program being undertaken at the DMO will have a positive impact on the efficiency of the acquisition process. However, the Committee is mindful of the external constraints that may hinder such a program and the time these changes may take to filter through.
- 4.132 The Committee is also satisfied that Defence is cognisant of the importance of developing and maintaining a detailed corporate compendium of knowledge and the Committee welcomes that Defence is instituting a more formal approach to documenting lessons learnt from acquisition projects. However, the Committee emphasises the need for every effort to be made to ensure all documented lessons learnt are clear and accessible so that all staff will be encouraged to seek out this information where necessary.

#### Cultural change

- 4.133 In its examination of the case studies, Defence 'culture' was frequently mentioned as an issue requiring attention from within Defence, industry and the Auditor-General.
- 4.134 Issues related to culture have often been cited in reviews of the Defence organisation. For example, both the *2003 Defence Procurement Review* and the *Senate Foreign Affairs, Defence and Trade References Committee's Report on the inquiry into materiel acquisition and*

---

121 Mr Tim Banfield, transcript, 20 June 2007, p 14.



*management in Defence* emphasised the need for cultural change across the Department. Indeed the latter report recommended the Senate request the Auditor-General conduct a cultural audit (i.e., an audit of the existing culture to identify strategies for cultural change) of the DMO.

- 4.135 The Committee accepts that a cultural shift has been documented anecdotally, for example, in the evidence set out below of internal observers such as Mr Malcolm Kinnaird of the Defence Procurement Advisory Board, Mr Phillip Prior, the CFO of Defence as well as external observers such as Mr Ron Fisher from Raytheon Australia Pty Ltd:

There is no doubt that the culture of the management group within DMO is now quite an improvement on what it was when we first started to look into the matter...I am convinced that there is a gradual shift going on from the top down.<sup>122</sup>

...

...I do see those changes and those shifts. Indeed, only yesterday I was presenting at a senior leadership forum on financial management. That is a forum for our one-, two- and three-star members and it is well attended. We hold those particular forums regularly. I must say that the level of interest and concern from the organisation at that level is still high and continues to be appropriately set. I can see that cultural shift coming through. I think the organisation is responding to these issues, so I think that cultural shift is occurring.<sup>123</sup>

...

The significance of Dr Gumley's reform agenda goes beyond the initiatives themselves to changing the culture and behaviour within the DMO. Changing the culture within the organisation is as important, if not more so, to improving the overall performance of the defence acquisition function as the initiatives themselves. Culture change takes time, and is a journey rather than a destination, but industry is very pleased that the journey has begun.<sup>124</sup>

---

122 Mr Malcolm Kinnaird, transcript, 15 August 2007, p 5.

123 Mr Phillip Prior, transcript, 29 March 2007, p 7.

124 Raytheon Australia Pty Ltd, sub 5, p 6.

- 4.136 However, the Committee remains concerned that while culture is, and has been, repeatedly raised in the context of inquiries such as this, it does not appear to have been systematically addressed, nor objectively measured in any great detail by the Department. This lack of empirical evidence makes it difficult for observers, including those responsible for parliamentary oversight of the Department, to determine the degree to which aspects of the Defence culture may, or may not, have changed. For example, while obviously a step in the right direction, it cannot be inferred that extensive training programs will *necessarily* bring about deep cultural change.
- 4.137 The idea of developing a measure to assess the degree to which cultural change has taken place was raised by Mr Mortimer, Chair of the Defence Procurement Advisory Board, at the hearing on 15 August 2007 as follows:
- The answer is that we have not actually tested it as such, but we asked the question of Steve [Gumley] about 18 months ago as to how far we are penetrating in the organisation and what would be the best way to test it. That is one of the reasons why we are still operating as a board. One of the ways to do that may well be a survey of some kind.<sup>125</sup>
- 4.138 The Committee believes that the evidence submitted in relation to the case studies has once again highlighted a number of cultural deficiencies across Defence. However, the Committee accepts that there is a significant amount of variability in performance across Defence which implies that one should be cautious when discussing Defence culture as a homogenous whole.
- 4.139 The Committee is also satisfied that cultural change is high on the list of Defence priorities. A number of Defence's senior leadership team have expressed both a concern with, and an agenda for, encouraging Defence personnel to, for example, understand and appreciate the significance of the work they do. The Committee also notes that the Department of Defence conducts a Defence Attitude Survey which contains questions related to *Personal Performance and Performance Culture*.
- 4.140 Yet, the Committee remains concerned that again, another Parliamentary inquiry is facing the task of determining whether the culture of Defence has, indeed, changed over the time since the Senate Foreign Affairs, Defence and Trade References Committee's 2003

---

125 Mr David Mortimer, transcript, 15 August 2007, p 5.

report and the 2003 *Defence Procurement Review*. The Committee believes, therefore, a more systematic and explicit focus on the measurement and monitoring of cultural change would be beneficial to both Defence and those responsible for parliamentary oversight of the Department.

## **Current status of the projects**

4.141 The Committee understands that as at July 2008, the status of the case studies is as follows:

### **FFG Upgrade Project**

4.142 In response to a question taken on notice at the hearing on 12 October 2006, Thales Australia provided an 'FFG Upgrade Delivery Schedule Table' on 15 November 2006. This table is set out in Appendix F.

4.143 Defence indicated, in a response to written questions dated 15 February 2007, that they had confidence in the delivery dates provided in this table. More specifically, they state:

A Deed of Settlement and Release was signed on 29 May 2006. ADI undertakings in the settlement of the re-baselined contract point to improved management practices and technical rigour. This has instilled considerably more confidence that the Program will achieve agreed and contracted delivery dates.<sup>126</sup>

4.144 Since that time, Thales have submitted a further update claiming that:

Since the May 2008 re-baseline, Thales has achieved delivery of all major milestones, in particular the return of ships to the Fleet on or before the scheduled date.<sup>127</sup>

4.145 At a Senate Additional Budget Estimates hearing on 20 February 2008 before the Standing Committee on Foreign Affairs, Defence and Trade, Mr Warren King, General Manager, Programs reported that none of the four FFGs being fitted with the upgrade were fully functioning at this stage. He also indicated that of the areas left that need to be addressed - the electronic surveillance measures (ESM)

---

<sup>126</sup> Department of Defence, sub 4.1 (response to Question W5).

<sup>127</sup> Thales Australia, sub 8.1, p 3.

system; the integrated logistics support in certain areas; and the towed array sonar - the ESM system was the most troubling.<sup>128</sup>

- 4.146 On 10 July 2008, before the Defence Subcommittee of the Joint Standing Committee on Foreign Affairs, Defence and Trade Estimates Commodore Andrew McKinnie, Director-General, Major Surface Ships, Maritime Systems Division of the DMO provided the following update:

The lead ship, HMAS *Sydney*, was offered for initial operational release and last year Chief of Navy elected not to take initial operational release due to his requirement for the capability to be improved prior to delivery. The key issues there were with the electronic surveillance system, which is a very high-sensitivity electronic warfare system, a very sensitive receiver, and it is all about detecting the electromagnetic environments and providing early warning and queuing for the above-water warfare combat systems. There were additional issues that he was concerned about in terms of the maturity of the integrated logistics support package and some issues about safety case documentation – in other words, making sure that we were delivering a capability that was safe and fit for service.

We have been working with the prime contractor, ADI Limited, now trading as Thales Australia, for some time and their subcontractor, Rafael, to work in a collaborative fashion to get the Rafael electronic surveillance system over the line. It is a C-Pearl ES system, electronic surveillance. We have had good progress and successes during this year of debugging the system, finding faults in software, finding faults in some of the inputs for that system, and we had a trials program in HMAS *Darwin* in May this year which has given us increased confidence that by about November this year we should be able to demonstrate a compliance system that meets the contracted requirements. It is on that basis that we wish to then reoffer that capability for Navy for consideration. It is important to the Chief of Navy in the context that this is a warning receiver and in his frame of reference it is a key issue in a decision to deploy the ship into combat operations. So we

---

128 Mr Warren King, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, pp 57-58

are on an ES system get-well activity to improve that capability.

There are other issues with the Link 11 tactical data link, which is also an important inter-operability and communications issue for deployment. That is being fast-tracked as best we can. We are working with the endgame in mind. We have a real determination to provide the best available capability to keep our Jacks and Jills at sea safe and to give the best delivery of that capability.

In the total capability requirement of this upgrade the real issue was major reliability programs and upgrade of the weapon systems, and many issues there have been well and truly demonstrated. We have major upgrades to the radar and sensor suites and they have been well and truly demonstrated. The anti-air warfare capability of the FFG is much improved with the installation of the evolved Sea Sparrow missiles and a Mark 41 vertical launching system in the forward part of the ship. That is a huge capability multiplier and we know that the ship is far superior in anti-air warfare terms to the pre-mod-up, pre-upgraded FFG. By the way, the Turkish Navy is seeking to leverage off our experience of that package involving the Sea Sparrow missile and vertical launching system, Mark 41, and they want to become a second customer of that development effort.

We have much of the ship capability demonstrated. We are on a get-well program to get over the line on the electronic warfare electronic surveillance systems and tactical datalinks and working with the contractors to deliver the best capability. The critical review point will be in November this year, which is a key contract milestone for delivery and acceptance of the lead ship, its combat systems and the supporting software.<sup>129</sup>

4.147 Dr Gumley cautiously reaffirmed that the situation with the FFG Upgrade Project appeared not to be as serious as it had been:

I am watching it carefully. It has been given a lot of senior professional attention. We have very good goodwill from the

---

129 Commodore Andrew McKinnie, transcript, 10 July 2008, pp 32-33.

company to try and pull it off, and I am more relaxed about it than I was previously.<sup>130</sup>

4.148 The Committee will continue to monitor the progress of this project.

### **Tiger Armed Reconnaissance Helicopter (ARH) Project – Air 87**

4.149 At a hearing on 1 March 2007, the Committee was informed that the through-life support contract with Australian Aerospace was currently under review. As Major General Tony Fraser, Head, Helicopter Systems Division, DMO states:

We will not accept that we should be paying additional through-life support costs on this aircraft until we review it after a five-year period.<sup>131</sup>

4.150 Additionally, media reports on 6 July 2007 indicated that Defence had stopped payment on the Tiger contracts. This was confirmed in evidence forwarded to the Committee on 13 August 2007 as follows:

Payment to Australian Aerospace Pty Ltd under the acquisition contract was suspended on 1 June 2007 due to the company's failure to meet the requirements of Initial Operational Capability. The primary cause of the failure to meet this milestone was the delay in the training of aircrew.<sup>132</sup>

4.151 At a Senate Additional Budget Estimates hearing on 20 February 2008 before the Standing Committee on Foreign Affairs, Defence and Trade, Major General Tony Fraser advised that ten of the fleet of twenty-two aircraft had now been accepted, twenty-two personnel had been trained and they had flown just over 2,400 hours. An eleventh aircraft was expected to be accepted within the week. Additionally, Major General Fraser advised that Defence were expecting an outcome on the negotiations regarding the through-life support contract by the end of March.<sup>133</sup>

4.152 With regard to the issue of payment, Major General Fraser advised that payment had not resumed causing "quite an impost"<sup>134</sup> on the

---

130 Dr Stephen Gumley, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 4 June 2008, p 93.

131 Major General Tony Fraser, transcript, 1 March 2007, p 15.

132 Department of Defence, sub 4.3 (response to question no 1).

133 Major General Tony Fraser, Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, p 71.

134 Major General Tony Fraser, Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, p 71.

company. In response to questioning about whether the company is continuing to work without payment, Major General Fraser reported as follows:

Significantly, and continuing to deliver the aircraft to us...but it is hurting them and that is why we are in negotiation to try to finalise this quickly.<sup>135</sup>

- 4.153 When asked about the current forecast time delay before all 22 aircraft would be accepted and meet performance standards, Major General Fraser advised the following:

You might recall...that the training that was initially to be done in France before they came to Australia ended up being two years behind schedule. That two years has essentially flowed right through the program, so it is about a two-year delay that we see throughout the program – at least to achieve initial operational capability for the first squadron. There is just a chance that we might be able to recover some of that schedule for the full capability...by some of the initiatives we are taking with lead-in skills training.<sup>136</sup>

- 4.154 On 22 May 2008, the Hon Greg Combet MP, Parliamentary Secretary for Defence Procurement, announced that “significant progress had been made on the remediation of Project AIR 87”.<sup>137</sup> Mr Combet MP further announced:

Following a period of negotiations between the Commonwealth and the contractor to resolve a dispute initiated in October 2007 over the contract provisions for Through Life Support as well as the Stop Payment, an agreement has been reached that will enable the project to deliver an operational capability to Army in the shortest practical time...Payment has resumed and the project is focussed on delivery of the Armed Reconnaissance Helicopter capability to Army.

The Deed of Agreement contains the basis for a Contract Change Proposal that transitions the current support contract

---

135 Major General Tony Fraser, Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, p 71.

136 Major General Tony Fraser, Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, pp 71-72.

137 The Hon Greg Combet MP, *Progress on Project Air 87 – Tiger Armed Reconnaissance Helicopters*, media release, 22 May 2008.

to a performance based structure, to reduce cost of ownership to the Commonwealth over time...<sup>138</sup>

- 4.155 On 10 July 2008, before the Defence Subcommittee of the Joint Standing Committee on Foreign Affairs, Defence and Trade, Major General Tony Fraser provided the following update on the Tigers:

Since negotiating a successful outcome through the dispute, the program has gained significant momentum. The aircraft in Australia has flown 2,700 hours, 24 personnel have trained, and the aircraft have been deployed to Darwin as of a week ago, at the end of June, importantly, into the regiment and into the operational capability to start that work. Importantly for us, the negotiation converted the through-life support contract from essentially what was a cost-plus type contract to a performance based contract, driving an incentive on the contractor therefore to reduce the total cost of ownership to the Commonwealth. It has also focused on delivering an operational capability to Army as quickly as we can possibly do so. I am very pleased with the new Australian Aerospace chief executive officer's work and the focus of the company to provide us that capability.<sup>139</sup>

- 4.156 Again, the Committee will continue to monitor this project.

## Conclusions

- 4.157 As outlined earlier, the issues raised in the context of the case studies were not new to the Committee. A lack of rigour and discipline around project/contract management and inventory control and a reticence to recover appropriate damages are matters with which the Committee, and indeed the Australian public are now well acquainted.
- 4.158 Similarly, discussion around the need for clarity in the meaning of significant concepts such as military-off-the-shelf, consideration of the manner by which risk is allocated between relevant parties, personnel

---

138 The Hon Greg Combet MP, *Progress on Project Air 87 – Tiger Armed Reconnaissance Helicopters*, media release, 22 May 2008.

139 Major General Tony Fraser, transcript, 10 July 2008, pp 4-5.



challenges and documenting lessons learnt were also issues that were reinvigorated during the inquiry.

- 4.159 However, the ongoing focus on these issues, described often and broadly as 'cultural issues' is something that brought into sharp relief the need for a more systematic approach to the measurement and monitoring of Defence culture.
- 4.160 The Committee is satisfied that Defence and in particular the DMO are well aware of the issues raised and the significant bearing they have on perceptions of the organisation as a competent, efficient agency. The Committee is also satisfied that the DMO is now focused on professionalising staff and practices in relation to project/contract management. Over the course of the inquiry the Committee heard a great deal of evidence about the upskilling of the DMO workforce and the importance placed on this by senior management.
- 4.161 Still, there remains an imperative for the Department to pay considerably more attention to documenting and measuring the changes that are taking, and have taken place, since the commencement of the implementation of the Kinnaird reforms.
- 4.162 A more systematic approach to monitoring major projects forms the focus of Chapter 5.

## Major Projects Report

### Introduction

- 5.1 One of the major frustrations the Committee experienced during this inquiry was an absence of clear, consistent and precise information on which to make an assessment about the status and history of troubled acquisition projects.
- 5.2 A lack of transparency around Defence acquisition projects is not a recent phenomenon. In its 2003 inquiry into materiel acquisition and management in Defence, the Senate Foreign Affairs, Defence and Trade References Committee reported:
- While the Committee acknowledges that there have been noticeable improvements in the ways in which progress on major projects is being reported to government, there is still relatively poor visibility of projects as far as the parliament and the public are concerned.<sup>1</sup>
- 5.3 That Committee recommended that the Senate request the Auditor-General to produce an annual report on progress in major defence

---

<sup>1</sup> Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p xv.

projects, detailing cost, time and technical performance data for each project.<sup>2</sup>

- 5.4 On 6 December 2006, this Committee unanimously agreed to recommend that the ANAO receive additional funding to produce such a report, published its recommendation and wrote to the relevant Ministers accordingly.
- 5.5 Drawing on the experience of other international organisations, in particular the National Audit Office of the United Kingdom, a model of the Defence Major Projects Report proposed by the ANAO in consultation with the DMO is set out below. This chapter also outlines a number of issues raised during the inquiry that are pertinent to the implementation of such a report.

## International models of reporting

- 5.6 Both the United Kingdom National Audit Office (UK NAO) and the United States Government Accountability Office (US GAO) have instituted assessment programs which seek to improve the level of transparency around Defence spending on procurement. In the UK, this program is the *Ministry of Defence Major Projects Report* and in the US, the program is titled *Defense Acquisitions Assessments of Selected Major Weapon Programs*.

## The US GAO Defense Acquisitions Assessments of Selected Weapon Programs

- 5.7 In its sixth and most recent report, the US GAO *Defense Acquisitions Assessments of Selected Major Weapon Programs* outlined its reasons for conducting the report as follows:

Since 2000, the Department of Defense (DOD) has roughly doubled its planned investment in new systems from \$790 billion to \$1.6 trillion in 2007, but acquisition outcomes in terms of cost and schedule have not improved...DOD's acquisition outcomes appear increasingly suboptimal, a condition that needs to be corrected...

...

---

2 Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p 79.

This report provides congressional and DOD decision makers with an independent, knowledge-based assessment of defense programs, identifying potential risks when a program's projected attainment of knowledge diverges from best practices.<sup>3</sup>

- 5.8 In the report, the US GAO evaluates performance and risk data from a number of programs (72 weapon systems were assessed in the 2008 report). The programs chosen for inclusion are selected as a result of several factors including high dollar value, acquisition stage, and congressional interest. The report is updated annually under the authority of the Comptroller General to conduct evaluations at his own initiative.<sup>4</sup>
- 5.9 Each individual assessment is provided to the responsible DOD program office and its comments are included in the final report. Additionally, the entire report is sent to the Office of the Secretary of Defense for comment. These comments are also included in the final report.<sup>5</sup>

## The UK NAO Ministry of Defence Major Projects Report

- 5.10 The Ministry of Defence (MOD) has reported annually to the UK Parliament on its progress in procuring major pieces of Defence equipment since 1984.
- 5.11 At present, projects qualify for inclusion if their forecast of future expenditure is among the twenty highest, for those that have achieved approval at the main investment decision and the ten highest for those projects still in the Assessment Phase. They are replaced as they progress through the procurement process and their estimated forecast costs reduce below the level of the top projects although their total costs may nonetheless be very high.
- 5.12 It is worth noting that the Major Projects Report is not a statutory account and the UK NAO does not offer a formal audit opinion on the accuracy of the data contained within it.

---

3 United States Government Accountability Office, *Highlights of GAO-08-467SP, a report to congressional committees*, March 2008, viewed 6 August 2008, <<http://www.gao.gov/new.items/d08467sp.pdf>>

4 United States Government Accountability Office, *Highlights of GAO-08-467SP, a report to congressional committees*, March 2008, viewed 6 August 2008, <<http://www.gao.gov/new.items/d08467sp.pdf>>

5 Mr Paul Francis, United States Government Accountability Office, e-mail, 6 February 2008.

- 5.13 The MOD compiles Project Summary Sheets according to agreed guidelines and the figures are calculated on a different basis to the Department's Resource Account. The summary sheets are made available to industry prime contractors for comment and amendment where appropriate. The UK NAO confirms that the Project Summary Sheets conform to the guidance and are accurately and consistently applied.
- 5.14 For the last 20 years the annual Major Projects Report has highlighted the variable performance of the Ministry of Defence's highest value defence equipment procurement projects, many of which have suffered cost overruns and delays.
- 5.15 This performance has been a matter of concern for both the Department and UK Parliament, and the Department has introduced a large number of reforms designed to improve project performance. Additionally, the National Audit Office has established a Defence Value for Money Team.
- 5.16 At the hearing on 20 June 2007, Mr Tim Banfield of the UK NAO informed the Committee that the NAO and the MOD had been working together to develop the report with a view to introducing some incremental changes from 2009 onward to provide a more complete account of the MOD's acquisition performance.<sup>6</sup>
- 5.17 These developments in the report were designed to reflect not only the changes to the MOD's acquisition philosophy that have taken place since the 1980s and 1990s but also to incorporate a greater appreciation of the context in which acquisitions now occur including but not limited to: the Defence Industrial Strategy; the increasing complexity of projects and long timescales between generations; and the importance of through life support costs.
- 5.18 The proposed changes to the Major Projects Report have now been submitted to the UK Public Accounts Committee and the principles for future work are foreshadowed as follows:
- Clear accountability to Parliament on the Department's acquisition performance on Major Projects through the validation of the Department's Project Summary Sheets along with an independent assessment of the summary sheet data provides an accurate, compliant, consistent audit trail and this should continue.

---

6 See transcript, 20 June 2007, p 12.

- Traditionally the Major Projects Report has examined the top 20 by value of the Department's post-Main Gate equipment procurement projects. It is proposed that this continues, but with three principal changes. Firstly, that the scope of the project population is widened to examine the full delivery of equipment into service i.e. delivery of Full Operating Capability. Secondly, that the examination is broadened to include not only the procurement of major equipment projects but also their associated long-term support arrangements and enhancements to capability. Thirdly, providing an overview of overall acquisition delivery to place performance of the Major Projects within the context of the overall portfolio of projects being managed by the Department.
- The future Major Projects Report would ultimately seek to ensure that the Public Accounts Committee is presented with a broader picture of equipment capability acquisition within the Department than currently achieved without decreasing the level and fidelity of the information currently presented to it. This needs however, to be proportionate, and against tight constraints on administration costs, the Department would be reluctant to invest effort in new forms of data collection which did not support the Department's business processes, and would expect the Committee to take the same view.
- The Department also needs to ensure that the changes to the [Major Projects Report] keep in step with the Defence Industrial Strategy and the associated Defence Acquisition Change Programme, while maintaining full transparency for Parliament.<sup>7</sup>

## Department of Defence, Major Projects Report

5.19 As referred to above, on 6 December 2006, the Committee announced that it had unanimously agreed to recommend that the ANAO receive additional funding to produce an annual report, based on data supplied by the Department of Defence and the DMO on progress of the top thirty capital equipment projects in Defence.

5.20 In correspondence dated 23 January 2007, the Committee was informed that the then Prime Minister, the Hon John Howard MP, and the then Minister for Finance and Administration,

---

<sup>7</sup> United Kingdom National Audit Office, correspondence, 19 March 2008, pp 2-3.

Senator the Hon Nick Minchin, supported the proposal. The Prime Minister requested the Department of Defence and the ANAO to bring forward a fully-costed and agreed model for consideration by ministers in the 2008-09 Budget.

5.21 In a written opening statement provided to the Committee at the hearing on 13 June 2007, the Auditor-General articulated the likely benefits of such a report:

Implementation of the Committee's recommendation in relation to the Top 30 projects will...provide evidence of Defence project management performance, and allow Defence to demonstrate the return on its very significant investment in improved management approaches, project management methodologies, systems and people.<sup>8</sup>

5.22 At that same hearing, the Committee was also provided with an update on the plans for monitoring the Defence's top projects. Representatives from the ANAO outlined the form the report would take and how the report could improve transparency around major Defence acquisition projects.

5.23 It is anticipated that the model adopted by the ANAO will be based on that of the UK Defence Major Projects Report. The DMO would prepare the base material on the status of each project and the ANAO would conduct an overview of that. Each summary sheet is expected to contain information on the following:

- **Project Description** which provides an overview of the project in the form of narratives covering the project's basic description, background, unique features, major risks and issues and current status.
- **Capital Investment and Prime Contractor Payments** which focuses on the project's budget approval history, its funds expenditure performance, contract price and equipment quantities to be delivered as well as progress payment history;
- **Technical Progress and Capability Delivery** covers the project's technical progress in terms of the scheduled and actual completion of the equipment design reviews, test and evaluations, and progress toward Initial and Full Operational Capability;

---

8 Mr Ian McPhee, Opening statement tabled at the hearing on 13 June 2007, p 2.

- **Risks, Issues and Linked Projects** lists the project's major risks and steps taken by DMO to prevent the risks from occurring. It also covers the risks that have actually occurred and so have evolved into actual issues that need management by DMO. Some projects depend on the success of other projects and this section addresses those projects in terms of what is the nature of the links (the dependency) and if the linked projects are at risk in terms of capability and schedule delivery; and
  - **Lessons Learnt** asks for any lessons learnt by the project that may be of benefit to other projects.<sup>9</sup>
- 5.24 Committee members experienced some difficulty in eliciting information about actions that had been taken and decisions that had been made at various points in ARH Project Air 87 and the FFG Upgrade Project. The intention of the Committee in gathering this information was not to apportion blame but rather to further elucidate where difficulties had arisen and how knowledge about those difficulties might contribute to future learning. The Committee understands and appreciates that the Major Projects Report will include details of responsible project staff such as the project director, branch head and other points of contact.
- 5.25 The Committee also understands that the date of project approvals (including both first and second pass) will be made available in the Major Projects Report. This would enable ready identification of projects where first and second pass approval has occurred concurrently.
- 5.26 On 13 June 2007, the Committee was informed by the Auditor-General, Mr McPhee that the ANAO was working with the DMO to develop a cabinet submission for consideration in the 2008-09 Budget.
- 5.27 The Committee is pleased to note that the Government has agreed to provide \$1.5 million annually to the Audit Office, from 2009-10 onwards, to conduct the Defence Major Projects Report with initial funding of \$750,000 in 2008-09.
- 5.28 The Committee stresses that maintaining adequate resources to this project is critical to ensure accountability and transparency of Defence procurement.

---

9 JCPAA Secretariat correspondence with the ANAO, 26 May 2008.



## Improving transparency

- 5.29 The Committee is very pleased at the prospect of having access to clear and consistent information on the progress of Defence acquisitions as anticipated by the Major Projects Report. It was apparent during the hearing that the lack of transparency around Defence projects reported by the Senate Foreign Affairs, Defence and Trade References Committee in March 2003 has improved little.
- 5.30 This Committee took evidence about a number of issues that impacted significantly on Defence's capacity to be transparent. These included the frequent use of ambiguous language and/or ill-defined terms, the need for a more holistic approach to reporting including a greater appreciation of the context in which these acquisitions are occurring, as well as the need to monitor projects over the whole of their acquisition life.
- 5.31 The Committee also reflected on the significance of the relationship between the ANAO, Defence and in particular the DMO with regard to the implementation of the Major Projects Report.

## Minimising ambiguity

- 5.32 As discussed in Chapter 4, concern about the use of ambiguous and inconsistent language was a common theme during this inquiry. While particularly notable in the case of ARH Project Air 87 with regard to the meaning of 'military-off-the-shelf', this type of ambiguity did feature over the inquiry as a whole. The use of a number of terms that clouded rather than clarified issues, raised concerns from witnesses both within and external to Defence.
- 5.33 For example, the term 'legacy project' was one that was frequently heard during the inquiry. At the hearing on 15 August 2007, Mr Malcolm Kinnaird equated the term 'legacy' with pre-Kinnaird projects<sup>10</sup> and in recent media reports it was claimed that 'legacy' was a term used by the DMO to describe projects with poor contracts or political baggage.<sup>11</sup> While it is clear that 'legacy' is a term attached to problematic projects, the Committee is concerned that this term may continue to be used *ad infinitum* to describe problematic projects. The

---

10 Mr Malcolm Kinnaird, transcript, 15 August 2007, p 4.

11 Ian McPhedran, *Defence deals on Rudd's hit list*, Herald Sun, 3 January 2008, p 2.

term lends an air of legitimacy to problems which might otherwise be deemed unacceptable.

- 5.34 A desire for clarity in language was not restricted to those outside Defence. For example, Dr Stephen Gumley also made the following point in relation to maintaining consistency in the language around 'pricing':

You talked earlier about nomenclature and jargon. For example, just in how you price a project you can have real prices, historical prices and outturn prices. If you look at something like the air warfare destroyer they can be billions of dollars apart depending on which definition you use. So it does lead to a lot of confusion in comparing two numbers. But that is a whole-of-government issue; you have to use different price definitions for different purposes.<sup>12</sup>

...

Quite often people say, 'You said it was going to be A, it looks like it is going to be B and now you are telling the me it is C.' In fact all three answers are correct. That is the definitional issue that you have.<sup>13</sup>

- 5.35 Similarly, 'cost blow out' is a well-known phrase. However, there appeared to be some disagreement about what that term actually depicts, possibly because of a lack of consensus around the meaning of terms such as 'cost', 'price' and the like. Mr Lewincamp, a representative of Defence, highlights this problem in his response to major Defence projects being characterised by major cost blow-outs:

I disagree with your characterisation about the scale of the problem that we face. In your opening comments about cost blow-outs and all the rest of it, a lot of that is a misrepresentation by the media. If you look at the analysis that has been done on schedule and on costs, you will see that a significant proportion of cost increases are related to price and exchange and a small percentage is due to real cost increases. Part of it is also due to changes in scope, where, if you change what you want to buy, clearly you have to pay a little bit more. The percentage of cost increases due to a cost blow-out is very small.<sup>14</sup>

---

12 Dr Stephen Gumley, transcript, 15 August 2007, p 8.

13 Dr Stephen Gumley, transcript, 15 August 2007, p 8.

14 Mr Frank Lewincamp, transcript, 29 March 2007, p 6.

- 5.36 Since 1982, Defence procurements in the United States have been subject to what is known as the *Nunn-McCurdy Amendment*. This amendment, designed to limit cost growth in major weapons programs, called for the termination of programs whose total costs exceeded original estimates by more than 25 per cent. Only systems certified as critical by the Secretary of Defense or cost growths attributable to specified program changes were exempt.<sup>15</sup>
- 5.37 The Committee is of the view that consideration should be given to developing a threshold as part of the definition of 'cost blow-out' in this country. This would serve to alert those with parliamentary oversight of Defence procurement to when a cost blow-out is a flag for concern rather than an explicable and justifiable relative increase in costs. This would also assist Defence to demonstrate when problems in Defence procurements have come about as a result of poor scheduling rather than cost issues.<sup>16</sup>
- 5.38 The Committee welcomes the evidence from Mr Meert of the ANAO at the hearing on 13 June 2007 that a glossary of terms is to be included in the Major Projects Report:

We also provided [the DMO] with an a normative glossary of terms because understanding things like even payments, we just have to be very clear that we and the committee know what these terms mean because if we then go and audit them the key for us is we do not want to generate any evidence, we just say within your own procurement guidelines, we will just get the paperwork to substantiate the data in here.<sup>17</sup>

## A holistic approach

- 5.39 Increasing transparency around major Defence acquisitions raised the need for additional information to enhance reporting. One issue centred on fostering a holistic approach to reporting. This would incorporate, for example, an acknowledgement of the distinction between the delivery of equipment and the delivery of

---

15 Center for Defense Information, viewed 25 March 2008, <<http://www.cdi.org/missile-defense/nunn-mccurdy.cfm>>

16 The Hon Greg Combet MP, *Speech by the Parliamentary Secretary for Defence Procurement on the 'DMO Business Plan Review'*, 20 June 2008.

17 Mr John Meert, transcript, 13 June 2007, p 11.

capability. This distinction is important and one that was also raised in the *Defence Procurement Review 2003*:

A central element of [Defence's definition of capability] is the need to consider capability as a connected whole and not as a collection of discrete parts...the acquisition of equipment is only one step in the process...<sup>18</sup>

- 5.40 Mr Tim Banfield of the National Audit Office of the United Kingdom also emphasised this distinction when he stated:

Actually having a piece of equipment delivered from industry does not mean that you can use it. So there is something about how you get to an operational capability level. I can give you an example of that which we looked at a couple of years ago – that is, our Apache attack helicopters. [They] were a very complicated procurement that was very successful. But they did not have trained pilots so they sat in sheds for two years until the pilots were trained. From the traditional MPR perspective that was success; but clearly in practice it was not.<sup>19</sup>

- 5.41 Mr Banfield makes the point that when capability is being purchased incrementally it is important to measure each increment and what has been delivered against those increments. The Committee was informed that the UK NAO was aiming to develop a system of monitoring that would provide:

...a better understanding...of not just how you deliver equipment capability but how you deliver capability in the round at the end of that.<sup>20</sup>

- 5.42 This evidence is reminiscent of the situation with ARH Project Air 87. As outlined previously, the primary contributor to the 24-month delay in schedule is related to training rather than the building of the aircraft. The Committee believes future monitoring of major Defence acquisition projects should clearly delineate between the delivery of capability as a whole and short-term contract performance (i.e., equipment received).

---

18 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*, p 22.

19 Mr Tim Banfield, transcript, 20 June 2007, p 3.

20 Mr Tim Banfield, transcript, 20 June 2007, p 3.

## Whole of life

- 5.43 On a related point, the importance of monitoring projects over the whole of their life was another issue raised during the inquiry. The Committee believes this is particularly important in circumstances where difficulties with projects tend to appear toward the latter end of their acquisition life. As Mr Colin Cronin from the ANAO states:

Projects generally, for the first half of their lives, seem to track well. It is in the second phase of life that all the problems seem to come out. The slippages tend to be towards the end.<sup>21</sup>

- 5.44 The Committee is aware that it is anticipated that projects included in the Major Projects Report, based on the current UK model, may include projects chosen on the basis of forward expenditure. However, the Committee is concerned that should such a model be adopted, projects may disappear and re-appear making tracking of these projects difficult. This difficulty was also highlighted by the Auditor-General in the following evidence:

One of the problems with that model is that in the UK their approach is taking an expenditure going forward and one of the problems with that is of course that some of the big projects drop out. As they come to the end of their development there is little expenditure and they drop out. Is that what the committee or the government really want?<sup>22</sup>

- 5.45 The Committee is keen to ensure that once projects are included in the Major Projects Report these projects are monitored in their entirety. To that end, the Committee notes the changes foreshadowed by the UK NAO to their Major Projects Report to widen the scope of the project population, take account of long-term support arrangements, and provide more information about the context in which acquisitions take place. The Committee also notes the following views of Mr Meert of the ANAO:

We are proposing more of a whole-of-life look at the projects. So when a project is on the top 30 it will stay in there. From the time a Defence service says to DMO, 'I want you to get me a platform that does x, y and z,' we will track it from there till the Navy accepts it.<sup>23</sup>

---

21 Mr Colin Cronin, transcript, 17 August 2006, p 7.

22 Mr Ian McPhee, transcript, 13 June 2007, p 4.

23 Mr John Meert, transcript, 13 June 2007, p 11.

## Context

- 5.46 It is apparent to the Committee that there is an increasing need for reporting on Defence acquisition to explicitly acknowledge the context in which these procurements are occurring. For example, as outlined previously (see Chapter 4) industry is an important player in the delivery of equipment and capability. All reporting and in particular that related to monitoring of the Major Projects Report should acknowledge the impact the capacity of industry has had on the progress of projects.
- 5.47 Representatives of the Department of Defence also made a call for the inclusion of more context into audit reports. As Mr Frank Lewincamp of the Department of Defence stated:
- In the audit reports, we would like to see a better contextual setting for the audit – an understanding of the strategic environment and the need for the capability – rather than just the far more detailed reporting. That is a work in progress. Over the next couple of years, I hope you will see more of that contextual setting in the reports.<sup>24</sup>
- 5.48 The committee is pleased to note that the proposed Major Projects Report will indeed incorporate information on the project context within the *Project Description* section.

## Relationship between the ANAO and the DMO

- 5.49 The quality of the relationship between the ANAO and the DMO was an issue of significance to the Committee particularly in light of the proposed Major Projects Report. It is clear that for this report to be conducted effectively, a healthy working relationship must exist between the ANAO and the DMO.
- 5.50 The Committee notes that the relationship between the ANAO and Defence with regard to financial statements audits is a generally positive one (see Chapter 2). However, the Committee also notes that with regard to performance audits the relationship appears to be somewhat more complicated.

---

24 Mr Frank Lewincamp, transcript, 29 March 2007, p 15.

5.51 Dr Gumley stated that while he believed the relationship with the Audit Office on financial audits was excellent, he was less positive about the performance audits:

...On the performance audits...it is my view that they could be done a lot more efficiently and effectively, and a greater level of transparency could be given to the government and to the public if we went about them a different way.<sup>25</sup>

5.52 The Committee was pleased to note the more recent comments of Dr Gumley, in response to questioning about the state of negotiations between the ANAO and the DMO on the guidelines for the Major Projects Report as follows:

There is a little bit of detail still to work out, but it is not in any way confrontational; it is very much cooperative. The Auditor will be the auditor and will determine what he wants to find, but we are doing our best to work with the needs and wants expressed by the Auditor.<sup>26</sup>

5.53 The Committee was interested to hear evidence from Mr Tim Banfield of the UK NAO on the quality of the relationship between that office and the UK Ministry of Defence. According to Mr Banfield, the quality of the relationship between the two organisations has “improved hugely”<sup>27</sup> over the 20 years since the inception of the major projects report. Mr Banfield attributes that improvement as follows:

I think that part of the reason is that we have grown some trust between one another. The major projects report is an MOD report to parliament, so it is for them to produce and us to validate. How we do that has really changed a lot. My team will be sat with the MOD in their offices for about nine weeks while we do the validation.<sup>28</sup>

5.54 Mr Banfield makes further comment on the positive impact the improved relationship between the agencies can have on efficiency:

[My team] will be sat with the central team in the ministry that is responsible for coordinating the report. That means

---

25 Dr Stephen Gumley, transcript, 9 May 2007, p 22.

26 Dr Stephen Gumley, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, p 72.

27 Mr Tim Banfield, transcript, 20 June 2007, p 5.

28 Mr Tim Banfield, transcript, 20 June 2007, p 5.

that when you have difficulties coming through in validation, when there are difficulties trying to get numbers, we can resolve those quickly and we can do it together. So the relationship now is very, very close. One of the examples of the effect that has had is that it used to take us 14 or 15 months from the date the report was meant to be covering before we published. We have now got that down to seven, and we have done that because we work closely. All of the analysis we do we do with them; we will sit down around a table and look at what the numbers say. It is our report; we are independent. But they have a perspective and they usually have some pretty good views on things. They have realised that they cannot pull the wool over our eyes, so there is some respect both ways round. But that has taken a while to get to.<sup>29</sup>

- 5.55 The Committee also heard evidence from Dr Gumley that the relationship between the MOD and the UK NAO had benefited a great deal as a result of reaching pre-agreement on the facts related to projects:

...the audit office and defence pre-agree all facts before anything was committed to writing, either draft reports or otherwise. You might get different interpretations, but facts are facts and they were all pre-agreed before things were committed to...that stopped about 80 per cent of the relationship problems between [the UK NAO] and the British MOD.<sup>30</sup>

- 5.56 The Committee is satisfied that the relationship between the ANAO and the DMO with regard to performance audits and development of the Major Projects Report is a functional one. However, the Committee will monitor the progress of that relationship in the context of reviewing the Major Projects Report.

## Current status of the Major Projects Report

- 5.57 The Committee understands that a model for the Major Projects Report is currently being trialled on several acquisition projects. Ms Jane Wolfe, General Manager, Corporate at Defence, provided an update on the pilot before the Senate Committee on Foreign

---

29 Mr Tim Banfield, transcript, 20 June 2007, p 5.

30 Dr Stephen Gumley, transcript, 15 August 2007, p 4.



Affairs, Defence and Trade Estimates hearing on 4 June 2008 as follows:

The first report will cover nine projects. The report for the first full year, which is next financial year, will cover at this stage an agreed 15 projects. That will include the nine that will be part of that first report to government.<sup>31</sup>

- 5.58 The Committee also notes that while the initial plans for the project identified that thirty projects would be included in this report (hence the original title of the *Top 30 Projects Report*), the evidence from Ms Wolfe indicates that this figure is in the process of being revised:

We started a discussion with the Audit Office about whether ultimately there will be 30 projects or whether that is too ambitious, given the feedback from the UK Audit Office, which was that, if you look at 20 to 25 two or three years down and you have built that first couple of years off the back of the nine and then the 15, you can start to do some deeper analysis of some of the issues that are starting to emerge. If you have a bigger number of projects, you have to do that analysis at a slightly shallower level.<sup>32</sup>

- 5.59 The DMO and the ANAO are currently in discussion about the utility of conducting a deeper analysis across a smaller number of projects.<sup>33</sup>

#### Committee comment

- 5.60 The Committee keenly awaits the pilot report which is anticipated to reach Parliament in November 2008. At that time, and in accordance with its statutory obligations, the Committee will review that report so that it may contribute to discussion on the direction of the Major Projects Report in subsequent years. Of particular interest to the Committee is determining the number of acquisition projects to be included in the Major Projects Report. It is the view of the Committee that reducing the number of projects to be included in the report could undermine the capacity for

---

31 Ms Jane Wolfe, Senate Standing Committee on Defence Foreign Affairs and Trade, Estimates, transcript, 4 June 2008, p 96.

32 Ms Jane Wolfe, Senate Standing Committee on Defence Foreign Affairs and Trade, Estimates, transcript, 4 June 2008, p 96.

33 Ms Jane Wolfe, Senate Standing Committee on Defence Foreign Affairs and Trade, Estimates, transcript, 4 June 2008, p 96.

Parliamentary scrutiny and therefore would warrant extensive justification.

## Conclusions

- 5.61 The appropriate model for the Major Projects Report may take some time to fully mature. The Committee is delighted that plans are moving apace to develop a strong foundation for this report so that difficulties with major Defence acquisition projects will be identified early in their development.
- 5.62 The Committee understands that it may also take some time for the relationship between the ANAO and the DMO to develop into the kind of positive relationship that now exists between the NAO and the Ministry of Defence in the United Kingdom. However, the Committee is hopeful that improvements in this relationship will not only enhance the visibility of Defence major acquisition projects but will lead to greater efficiencies such as reducing the time taken to produce the report.
- 5.63 The Department of Defence and in particular the DMO have been subject to intense scrutiny over recent years. The Committee hopes that increasing transparency around Defence major acquisition projects, through the Major Projects Report, may lessen the likelihood of inquiries being referred to Parliamentary Committees.
- 5.64 The Committee also believes that demarcation between the activities of various parliamentary committees and reporting arrangements may aid overall transparency. It may therefore be beneficial if committees discuss their interests in the Defence portfolio in a bid to avoid overlap and duplication. For example, the JCPAA could assume a formal role in reviewing the Major Projects Report. The Senate could continue its Estimates role and other major inquiries could be conducted as appropriate by the Joint Standing Committee on Foreign Affairs Defence and Trade and the Senate Foreign Affairs, Defence and Trade References Committee.
- 5.65 The implementation of the Major Projects Report does not eclipse the Auditor-General's right to audit any project he so chooses and the Committee is firmly of the view that while individual full performance audits on all the projects contained in the Major

Projects Report will not be possible or desirable, performance audits of any project the Auditor-General deems appropriate should continue to be undertaken without hesitation. In particular, the Committee would encourage performance audits which examine acceptance into service and full operational capability.

- 5.66 A question that has exercised the Committee is the extent to which the Major Projects Report will indeed improve performance. To that end, the Committee notes the experience of Mr Tim Banfield of the UK NAO as follows:

One of the other important aspects that I would emphasise is that the major projects report is just part of the way that parliament scrutinises the Ministry of Defence. It gives it a really good overview of trends over time and a snapshot of what is happening now. We also produce reports looking at individual projects in much more detail and at some of the systemic issues. We recognise that, for the 24 years now that we have had major projects reports, there has been no appreciable change in performance despite lots of sensible initiatives.<sup>34</sup>

- 5.67 Mr Banfield further explained:

If you take the trends that the major projects report shows year on year then you get fluctuations – you get a few bad years and a few good years – but overall there is no appreciable improvement in cost performance or time performance. That actually is a really unfair measure because from all of the other work that we do our Ministry of Defence is getting better. The challenge of those projects is increasing as well so it is an example of why the major projects report, as it is now, is not a particularly fair way of gauging performance with some of those things.<sup>35</sup>

- 5.68 The Committee is acutely aware that while the Major Projects Report constitutes a significant and timely step toward improving transparency around major acquisition projects within Defence and the DMO, it is not, in and of itself, a panacea for reducing schedule slippages, cost overruns and the like. For example, it is only through an intensive and sustained effort in professionalising

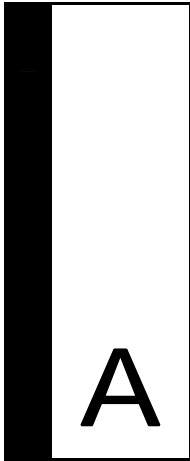
---

34 Mr Tim Banfield, transcript, 20 June 2007, p 2.

35 Mr Tim Banfield, transcript, 20 June 2007, p 4.

DMO personnel that project management practices will be characterised by rigour and discipline.

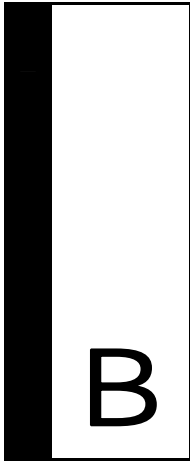
- 5.69 However, the Committee is optimistic that the Major Projects Report will put the ANAO and the Parliament in a much stronger position. Project management practices can be reviewed while major projects are still in train rather than looking retrospectively via an audit and/or parliamentary review some time after failures have occurred.
- 5.70 The Committee also believes that the continuous monitoring provided by the Major Projects Report will assist in promoting cultural and attitudinal change in the management of Defence projects.



## Appendix A – List of submissions

- 1 Mr Ian Matthews
- 2 BAE SYSTEMS Australia Limited
- 3 Australian National Audit Office
- 3.1 Australian National Audit Office  
(Supplementary to Submission No. 3)
- 4 Department of Defence
- 4.1 Department of Defence  
(Supplementary to Submission No. 4)
- 4.2 Department of Defence  
(Supplementary to Submission No. 4)
- 4.3 Department of Defence  
(Supplementary to Submission No. 4)
- 4.4 Department of Defence  
(Supplementary to Submission No. 4)
- 4.5 Department of Defence  
(Supplementary to Submission No. 4)
- 4.6 Department of Defence  
(Supplementary to Submission No. 4)
- 4.7 Department of Defence  
(Supplementary to Submission No. 4)

- 5 Raytheon Australia Pty Ltd
- 6 Mr Joe Moharich
- 7 Mr Peter Goon
- 8 Thales Australia
- 8.1 Thales Australia  
(Supplementary to Submission No. 8)
- 9 CONFIDENTIAL
- 10 CONFIDENTIAL
- 11 Mr Ray Conroy



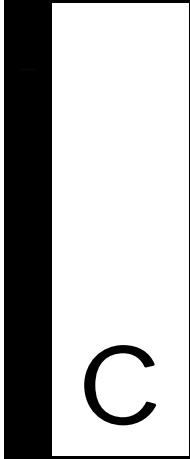
## Appendix B – List of exhibits

- 1 Department of Defence  
*FFG Upgrade Lessons Learnt*
  
- 2 Department of Defence  
*Defence Portfolio Additional Estimates Statements 2006-07*
  
- 3 Department of Defence  
*Proposed Amendments to AASB 102 - Inventories Held for  
Distribution by Not-For-Profit entities - March 2007*
  
- 4 Defence Materiel Organisation  
*Key Note speech to 4th Annual ADM Congress 22 February 2007*
  
- 5 Defence Materiel Organisation  
*Know your customer. Slide presentation to ADM Congress  
22 February 2007*

- 6 Australian National Audit Office  
*Correspondence: From the Australian National Audit Office to the Defence Material Organisation*
- 7 National Audit Office (UK)  
*Good Governance - Measuring Success Through Collaborative Working Relationships*
- 8 National Audit Office (UK)  
*Ministry of Defence - Using the contract to maximise the likelihood of successful project outcomes*
- 9 National Audit Office (UK)  
*Ministry of Defence - Major Projects Report 2005*
- 10 National Audit Office (UK)  
*Ministry of Defence - Major Projects Report 2006*
- 11 National Audit Office (UK)  
*Ministry of Defence - Major Projects Report 2005: Project Summary Sheets*
- 12 National Audit Office (UK)  
*Ministry of Defence - Driving Successful Delivery of Major Defence Projects: Drawing on Wider Practice in Tracking the Progress of Major Projects*
- 13 National Audit Office (UK)  
*Ministry of Defence - Driving the Successful Delivery of Major Defence Projects: Effective Project Control is a Key Factor in Successful Projects*



- 
- 14 Department of Defence  
*Summary of lessons learned from the FFG Upgrade Project*
- 15 Department of Defence  
*'DMO Business Plan Review' Monthly presentation by Chief Executive Officer DMO*



## Appendix C – List of public hearings

**Thursday, 11 May 2006 - Canberra**

**Department of Defence**

Lieutenant General David Hurley AO, DSC,  
Chief Capability Development Group

Mr Phillip Prior, Chief Finance Officer

Mr Ric Smith AO, Secretary

**Defence Materiel Organisation**

Dr Stephen Gumley, Chief Executive Officer

Dr Ian Williams, Chief Finance Officer

**Thursday, 17 August 2006 - Canberra**

**Australian National Audit Office**

Mr Colin Cronin, Executive Director

Mr Ian McPhee, Auditor-General

Mr John Meert, Group Executive Director

Mr Michael Watson, Group Executive Director

Mr Michael White, Executive Director

**Thursday, 12 October 2006 - Canberra**

**ADI Limited**

Mr Ali Baghaei, Vice President, Thales Naval Australia

Mr David Sippel, Program Manager, FFG Upgrade Project

Mr Harley Tacey, Project Director, FFG Upgrade Project

**Australian National Audit Office**

Mr Colin Cronin, Executive Director

Dr Ray McNally, Senior Director

Mr Ian McPhee, Auditor-General

Mr John Meert, Group Executive Director

**Thursday, 19 October 2006 - Canberra**

**Australian Aerospace**

Mr Brendan Roberts, Director of the Board

Mr Joseph Saporito, Chief Executive Officer

Mr Bob Wilson, Acquisition Contract Manager

**Australian National Audit Office**

Mr Darren Coonan, Senior Director

Mr Colin Cronin, Executive Director

Mr Ian McPhee, Auditor-General

Mr John Meert, Group Executive Director

**Thursday, 7 December 2006 - Canberra**

**Australian National Audit Office**

Mr Steve Chapman, Deputy Auditor-General

Mr Darren Coonan, Senior Director

Mr Colin Cronin, Executive Director

Dr Ray McNally, Senior Director

Mr John Meert, Group Executive Director

Mr Michael White, Executive Director

#### Defence Materiel Organisation

Mr Mal Adams, Director, FFG Systems Program Office

Major General Tony Fraser, Head, Helicopter Systems Division

Mr Kim Gillis, Deputy Chief Executive Officer

Dr Stephen Gumley, Chief Executive Officer

Commander Drew McKinnie, Director General, Major Surface Ships

Rear Admiral Trevor Ruting, Head, Maritime Systems Division

#### Thursday, 8 February 2007 - Canberra

##### Individuals

Mr Ian Matthews

Dr Mark Thomson

##### BAE SYSTEMS Australia Limited

Mr Harry Bradford, Chief Operating Officer

Mr Peter Nicholson, Government Relations Director

#### Thursday, 1 March 2007 - Canberra

##### Defence Materiel Organisation

Mr Mal Adams, Director, FFG Systems Program Office

Brigadier Andrew Dudgeon, Director General

Major General Tony Fraser, Head, Helicopter Systems Division

Mr Kim Gillis, Deputy Chief Executive Officer

Dr Stephen Gumley, Chief Executive Officer

Commander Drew McKinnie, Director General, Major Surface Ships

Rear Admiral Trevor Ruting, Head, Maritime Systems Division

### Wednesday, 28 March 2007 - Canberra

#### Individuals

Mr Joe Moharich

#### Raytheon Australia Pty Ltd

Mr Ronald Fisher, Managing Director

### Thursday, 29 March 2007 - Canberra

#### Department of Defence

Mr Mark Jenkin, Acting First Assistant Secretary

Mr Phillip Prior, Chief Finance Officer

#### Defence Materiel Organisation

Mr Frank Lewincamp, Chief Operating Officer

Mr Timothy Youngberry, Chief Financial Officer

### Wednesday, 9 May 2007 - Canberra

#### Department of Defence

Lieutenant General David Hurley AO, DSC,  
Chief Capability Development Group

#### Defence Materiel Organisation

Dr Stephen Gumley, Chief Executive Officer

**Wednesday, 23 May 2007 - Canberra****Defence Science and Technology Organisation**

Dr Roger Lough, Chief Defence Scientist

**Department of Defence**

Lieutenant General David Hurley AO, DSC,  
Chief Capability Development Group

**Wednesday, 13 June 2007 - Canberra****Australian National Audit Office**

Mr Colin Cronin, Executive Director

Mr Ian McPhee, Auditor-General

Mr John Meert, Group Executive Director

Mr Michael Watson, Group Executive Director

Mr Michael White, Executive Director

Mr Peter White, Executive Director

**Wednesday, 20 June 2007 - Canberra****National Audit Office (UK)**

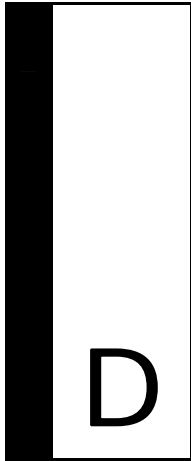
Mr Tim Banfield, Director

**Wednesday, 15 August 2007 - Canberra****Defence Materiel Organisation**

Dr Stephen Gumley, Chief Executive Officer

Mr Malcolm Kinnaird AO, Board Member, Defence Procurement  
Advisory Board

Mr David Mortimer AO, Chairman, Defence Procurement Advisory  
Board



## Appendix D – List of inspections

**Monday, 13 November 2006 - Qantas**

**Qantas Airways Limited**

Mr Tony White, GGM Strategic Procurement

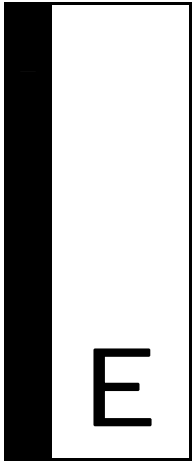
**Monday, 2 April 2007 - Qantas**

**Qantas Airways Limited**

Mr Ben Scholz, GM Supply Chain Operations

Mr Geoff Simmonds, National Operations Manager

Mr Tony White, GGM Strategic Procurement



Appendix E – Financial reporting  
challenges facing selected international  
Defence organisations



### Financial Reporting Challenges Facing Selected International Defence Organisations

	Required to prepare financial statements as a Stand Alone agency	Required to implement IFRS	Specific Accounting Challenges				
			Challenges maintaining records of Inventory	Required to maintain Employee Leave Entitlements records for long term	Required to report Embedded Derivatives	Required to provide for Restoration and Decontamination	Required to recognise and value Heritage and Cultural assets
Australia	Yes	Yes 30 June 2006	Yes	Yes	Yes	Yes	Yes
New Zealand	Yes	Yes 30 June 2008	No	No	No	Yes	No
United Kingdom	Yes	No	Yes	No*	No	No	No
United States	No**	No	Yes	Unknown	Unknown	Yes	Unknown

\* The United Kingdom does not have entitlements similar to Australia. As a consequence it does not recognise a provision for employee long service leave in its financial statements.

\*\* The United States Department of Defense did not produce published financial statements due to the Department's continuing self qualification of accounts.

Source: *Department of Defence, sub 4, p 61.*

#### New Zealand: New Zealand Defence Force

Stand Alone Financial Statements	Audited Financial Statements	IFRS Adoption Timing	Accrual Accounting	Audit Qualifications Experienced			Financial Statement Remediation
				2002-03	2003-04	2004-05	
Yes	Yes	30 June 08	Yes	No	No	No	Limited

Source: *Department of Defence, sub 4, p 63.*

#### United Kingdom: Ministry of Defence

Stand Alone Financial Statements	Audited Financial Statements	IFRS Adoption Timing	Accrual Accounting	Audit Qualifications Experienced			Financial Statement Remediation
				2002-03	2003-04	2004-05	
Yes	Yes	Unknown	Yes	No	No	Major – Complete	

Source: *Department of Defence, sub 4, p 65.*

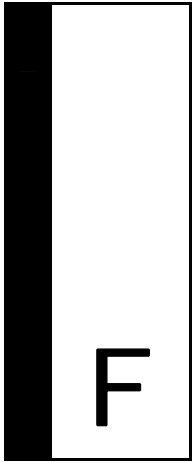
United States: Department of Defense

Stand Alone Financial Statements	Audited Financial Statements	IFRS Adoption Timing	Accrual Accounting	Audit Qualifications Experienced			Financial Statement Remediation
				FY 2003	FY 2004	FY 2005	
Yes	No	Unknown	Unknown	Yes	Yes	Yes	Major – In Progress

Source: Department of Defence, sub 4, p 70.

Stand Alone Financial Statements	Audited Financial Statements	IFRS Adoption Timing	Accrual Accounting	Audit Qualifications Experienced			Financial Statement Remediation
				2002-03	2003-04	2004-05	
Yes	No	Unknown	No	No	No	No	Unknown, but likely

Source: Department of Defence, sub 4, p 73.



## Appendix F – FFG Upgrade Project delivery schedule

**FFG UPGRADE PROJECT DELIVERY SCHEDULE, as at 31 October 2006.**

Delivered Item see Note 1	Scheduled Provisional Acceptance Date, as at July 2000 see Note 2	Contractor Delivery to DMO (Handback*)	Revised Provisional Acceptance ** by DMO (CCP0255)	Acceptance*** By DMO	Final Acceptance**** by DMO see Note 3
Lead FFG Upgrade	17 May 2003	28-Apr-06 (Handback)	15-Dec-06	18-Nov-08	31-Dec-09
2nd FFG Upgrade	16 January 2004	24-Apr-07 (Handback)	12-Oct-07	18-Nov-08	31-Dec-09
3rd FFG Upgrade	11 July 2004	10-Mar-08 (Handback)	26-Aug-08	18-Nov-08	31-Dec-09
4th FFG Upgrade	5 January 2005	11-Dec-08 (Handback)	3-Jun-09	3-Dec-09	31-Dec-09
Team Trainer	4 March 2005	N/A see Note 4	15-Feb-07	31-Dec-09	31-Dec-09
Warfare Systems Support Centre (WSSC)	4 June 2004	N/A see Note 4	18-Nov-08	31-Dec-09	31-Dec-09
Upgraded Software	4 May 2004 (Acceptance)	N/A see Note 4	N/A	18-Nov-08	31-Dec-09
Long Lead Spares	17 May 2003	N/A see Note 4	2-Jun-05	31-Dec-09	31-Dec-09
Operator Training	July 2002	N/A see Note 4	N/A	N/A	N/A

**Note 1.** This table is based upon the Items listed in the Price & Delivery Schedule - Attachment A, Schedule 1. A number of other Items are now in the current Schedule 1 list. Dates are based upon Attachments A,D & L. as applicable for Handback, Provisional Acceptance and Acceptance.

**Note 2.** Audit Report No. 45 2004/2005, Management of Selected Defence System Program Offices, p.72, Table 7.1.

**Note 3.** Original Contract (1 June 1999) the Contract Final Acceptance date was September 2006.  
CCP0086 (CA0112 29 April 04) changed Contract Final Acceptance date to October 2008.  
CCP0255 (CA0185 2 June 06) changed Contract Final Acceptance date to 31 December 2009. (RAN Caveat of no more than 2 FFGs in Upgrade at any one time)

**Note 4.** N/A as Handback only applies to FFG ships.

\* **Handback** means the return of an FFG to the Commonwealth, including for the operational requirements of the RAN (which use shall not constitute Provisional Acceptance or Acceptance under the Contract)

\*\* **Provisional Acceptance** means the certification by the Project Authority that the Contractor has fulfilled its contractual obligations in respect of any upgraded FFGs or upgraded facilities listed on a Supplies Release Note (SG8), subject to any omissions or defects listed on that SG8, and that those upgraded FFGs or upgraded facilities conform with the requirements of the Contract, and Provisional Acceptance is subject to Acceptance and Final Acceptance. Provisional Acceptance is signified by the Project Authority signing an SG8.

\*\*\* **Acceptance** means the certification by the Project Authority that the Contractor has fulfilled its contractual obligations in respect of any item or items of the Supplies or for an upgraded FFG or upgraded facility or Upgraded Software listed on an SG1, subject to any omissions or defects listed on that SG1, and that those Supplies or upgraded FFG or upgraded facility or Upgraded Software conform with the requirements of the Contract, and Acceptance is subject to Final Acceptance.

\*\*\*\* **Final Acceptance** means the certification by the Project Authority that the Contractor has fulfilled all its contractual obligations in respect of achieving Acceptance of the Upgraded FFGs, Acceptance of the Upgraded Facilities, Acceptance of the Upgraded Software and Acceptance of those Supplies required to be supplied prior to Final Acceptance, subject to any omissions or defects listed on an SG1, and that the FFGs, facilities, Upgraded Software and all of the Supplies conform with the requirements of the Contract. Final Acceptance is signified by the Project Authority signing an SG1.